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Productivity Commission

Executive Remuneration in Australia

Productivity Commission Inquiry Report

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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19 December 2009

The Honourable Nick Sherry MP
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report into Executive Remuneration in Australia.

Yours sincerely

Gary Banks AO	Robert Fitzgerald AM	Prof Allan Fels AO
Chairman	Commissioner	Associate Commissioner

Terms of reference

Review into the Regulation of Director and Executive Remuneration in Australia

I, CHRIS BOWEN, Assistant Treasurer, under part 3 of the *Productivity Commission Act 1998*, hereby request that the Productivity Commission undertake an inquiry into the current Australian regulatory framework around remuneration of directors and executives, as it applies to companies which are disclosing entities regulated under the *Corporations Act 2001* and report within nine months of the date of receipt of this reference.

This review is intended to complement the work already underway in relation to executive remuneration practices by regulated financial institutions. Last year, the Prime Minister announced that the Australian Prudential Regulation Authority would develop a template that links capital adequacy requirements to executive remuneration practices in order to limit excessive risk taking in financial institutions.

Background

The remuneration of company directors and executives is an issue which has attracted considerable interest from shareholders, business groups and the wider community. Concerns have been raised over excessive remuneration practices, particularly as we face almost unprecedented turmoil in global financial and equity markets.

The current global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed. The crisis has also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia's corporate directors and executives.

It is also important to recognise that internationally competitive reward structures for company directors and executives continue to provide incentives for directors and executives to assume leadership responsibilities within corporations.

Internationally, remuneration practices have been identified by various forums as a contributing factor to the global financial crisis. The Group of Twenty (G-20) and the Financial Stability Forum are both examining remuneration issues to ensure effective governance and oversight of executive remuneration is part of their responses to the crisis. In addition, the United Kingdom and the United States have imposed conditions on remuneration for entities that have received the benefit of recent corporate bailouts and government assistance packages.

Scope of the review

In undertaking the review the Commission should:

1. Consider trends in remuneration in Australia, and internationally, including, among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long term and equity-based payments and termination benefits and the relationship between remuneration packages and corporate performance.
2. Consider the effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices in Australia including:
   - the role, structure and content of remuneration disclosure and reporting;
   - the scope of who should be the subject of remuneration disclosure and approving remuneration packages
   - the role of boards and board committees in developing and approving remuneration packages
   - the role of other stakeholders, including shareholders, in the remuneration process
   - the role of, and regulatory regime governing, termination benefits
   - the role of, and regulatory regime governing, remuneration consultants, including any possible conflicts of interest
   - the issue of non-recourse loans used as part of executive remuneration and
   - the role of non-regulatory industry guidelines and codes of practice.
3. Consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices.

4. Consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including but not limited to:
   - the role of equity-based payments and incentive schemes
   - the source and approval processes for equity-based payments
   - the role played by the tax treatment of equity-based remuneration
   - the role of accelerated equity vesting arrangements and
   - the use of hedging over incentive remuneration.
5. Consider the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances.
6. Liaise with the Australia's Future Tax System Review and the Australian Prudential Regulatory Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of this Review.
7. Make recommendations as to how the existing framework governing remuneration practices in Australia could be strengthened.

The Commission is to undertake an appropriate public consultation process including the invitation of public submissions.

CHRIS BOWEN

[19 March 2009]

Contents

The following appendixes are not included in this Report. They are available on the inquiry website (www.pc.gov.au/projects/inquiry/executive-remuneration)

Abbreviations and explanations

Abbreviations

AASB	The Australian Accounting Standards Board
ACSI	Australian Council of Super Investors
ACTU	Australian Council of Trade Unions
AHRI	Australian Human Resources Institute
AICD	Australian Institute of Company Directors
AMWU	Australian Manufacturing Workers' Union
APRA	Australian Prudential Regulation Authority
ASA	Australian Shareholders' Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ASX100 companies	The largest 100 companies listed on the Australian Securities Exchange
AWE	average weekly earnings
BCA	Business Council of Australia
CEO	chief executive officer
CFMEU	Construction, Forestry, Mining and Energy Union
CGT	capital gains tax
CLERP	Corporate Law Economic Reform Program
CSA	Chartered Secretaries Australia
GST	goods and services tax
IFSA	Investment and Financial Services Association
LTI	long-term incentive
NASDAQ	National Association of Securities Dealers Automated Quotations

NED	non-executive director
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
S&P	Standard and Poor's
STI	short-term incentive
TSR	total shareholder return

Explanations

Billion	The convention used for a billion is a thousand million (10^9).
Findings	*Findings in the body of the report are paragraphs high-lighted using italics, as this is.*
Recommendations	***Recommendations in the body of the report are high-lighted using bold italics with an outside border, as this is.***

OVERVIEW

Key points

- Strong growth in executive remuneration from the 1990s to 2007, and instances of large payments despite poor company performance, have fuelled community concerns that executive remuneration is out of control.
- Pay for CEOs of the top 100 companies appears to have grown most strongly, at 13 per cent real a year, from the mid-90s to 2000, and then increased by around 6 per cent annually in real terms to 2007. Since 2007 average remuneration has fallen by around 16 per cent a year, returning it to 2004-05 levels.
  - The rise and decline in executive pay over the 2000s largely reflects increased use of pay structures linked to company performance.
- Executive pay varies greatly across Australia's 2000 public companies.
  - For the top 20 CEOs, in 2008-09 it averaged $7.2 million (110 x AWE) compared to around $260 000 for CEOs of the smallest listed companies (4 x AWE).
  - Generally speaking, Australian executives appear to be paid in line with smaller European countries, but below the UK and USA (the global outlier).
- Liberalisation of the Australian economy and global competition, increased company size, and the shift to incentive pay structures, have been major drivers of executive remuneration — companies compete to hire the best person for the job, and try to structure pay to maximise the executive's contribution to company performance.
- Nonetheless, some past trend and specific pay outcomes appear inconsistent with an efficient executive labour market, and possibly weakened company performance.
  - Incentive pay 'imported' from the United States and introduced without appropriate hurdles spurred pay rises in the 1990s partly for 'good luck'. More recently, complex incentive pay may have delivered unanticipated 'upside'.
  - Some termination payments look excessive and could indicate compliant boards.
- Instances of 'excessive' payments and perceived inappropriate behaviour could also reduce investor and community trust in the corporate sector more broadly, with adverse ramifications for equity markets.
- But the way forward is not to by-pass the central role of boards. Capping pay or introducing a binding shareholder vote on it would be impractical and costly.
- Instead, the corporate governance framework should be strengthened by:
  - removing conflicts of interest, through independent remuneration committees and improved processes for use of remuneration consultants;
  - promoting board accountability and shareholder engagement, through enhanced pay disclosure and strengthening the consequences for those boards that are unresponsive to shareholders' 'say on pay'.
- These reforms would significantly reduce the likelihood in future of inappropriate remuneration outcomes, or those that shareholders would find objectionable.

Overview

A catalyst for this inquiry was concern that executive pay had got out of hand. This perception was fuelled by practices in financial institutions abroad that were seen as a key contributor to the global financial crisis (GFC). Further, while local shareholder value plummeted in 2008 as a result of that imported crisis — with some companies and sectors being propped up by taxpayers — executive pay seemed to emerge unscathed, crystallising a view that executives were being rewarded for failure (after having been rewarded for success).

This has come on top of longstanding community discomfort about the widening gap between the remuneration of executives and other employees, as well as some large termination payments with perceived lack of justification. Public opinion polling over the years consistently shows that most respondents believe executives to be overpaid. But polls also reveal limited awareness of the drivers of executive pay and wealth creation.

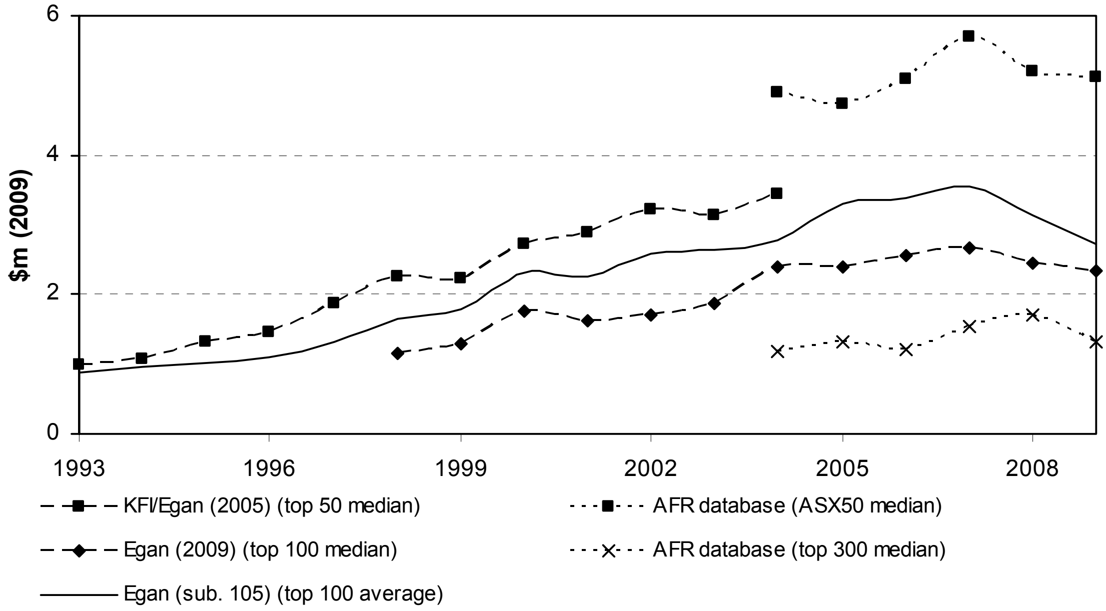
Accordingly, this inquiry was tasked with ascertaining what has actually happened to executive pay in Australia's publicly-listed companies, as well as identifying what can and should be done about it. The appropriate test for any policy intervention is that it promotes community wellbeing: hence the Commission has explored the likely drivers of executive pay and the economic implications of current pay levels and structures. Ultimately, judgment must be exercised, particularly in relation to the magnitude of identified problems and the case for intervention, taking into account both the potential costs and benefits.

Some 'facts' about executive pay

Notwithstanding a lack of consistent data over the longer term, on any measure remuneration for executives of larger companies has grown strongly overall since the early 1990s (figure 1). Depending on the sample used, CEO remuneration at the 50–100 largest Australian listed companies increased between 1993 and 2007 by as much as 300 per cent in real terms. Since 2007, this trend has been reversed to some degree, with pay returning to levels recorded in 2004-05. (The story for non-CEO executives is similar, but with slightly lower growth rates and much lower levels.

Pay for non-executive directors (NEDs) — which is paid as a fixed amount in cash or shares — grew by around 9 per cent per year from 1993 to 2007.)

Figure 1 **Trend executive pay growth in large companies**



In 2008-09, estimated total remuneration for CEOs of the top 20 companies averaged approximately $7.2 million, or 110 times average wages (figures 2 and 3). CEOs of the next 20 biggest companies had remuneration packages valued about one third less (approximately $4.7 million). Multi-million dollar packages all but disappear for companies ranked 150–200, while for the smallest of Australia's almost 2000 publicly-listed companies, CEO remuneration averaged around $260 000 (or approximately four times average wages).

Remuneration levels also vary significantly across industries, being highest in the finance, telecommunications and consumer sectors, and lowest for the CEOs of information technology and utility companies.

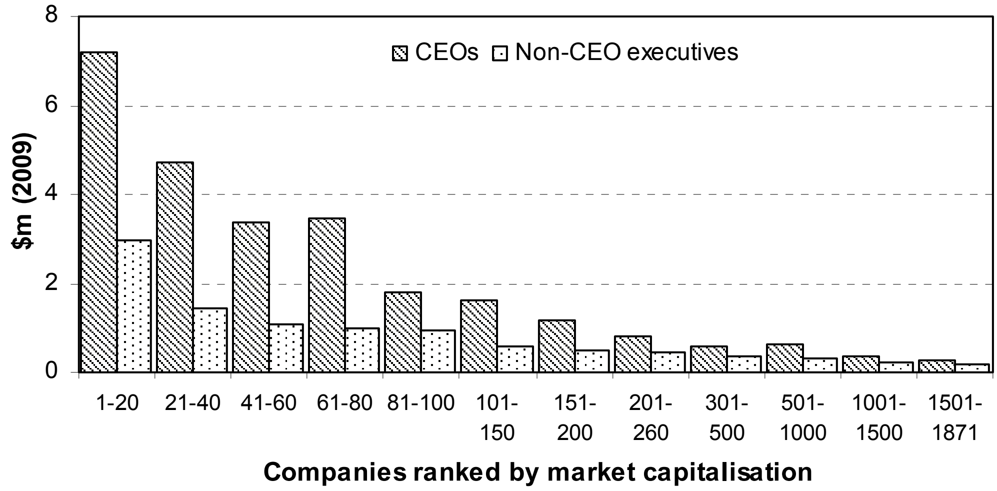
While there are no consistent long-run time series for executive pay (because of evolving disclosure rules), the different series available suggest:

- CEO pay grew most strongly from the mid 1990s to 2000 — at around 13 per cent a year in real terms for the top 100 companies and 16 per cent for the ASX50
- from 2000 to 2007, annual real growth moderated to 6 per cent for the top 100 companies, but still led to a 50 per cent increase overall

- between 2006-07 and 2008-09, real total CEO pay fell across ASX300 companies, especially for the top 100 (which have proportionately more pay linked to company performance). The decline in average total remuneration for CEOs of ASX100 companies over the two-year period was approximately 16 per cent per year, in real terms.

Figure 2 **Executive pay rises with market capitalisation**

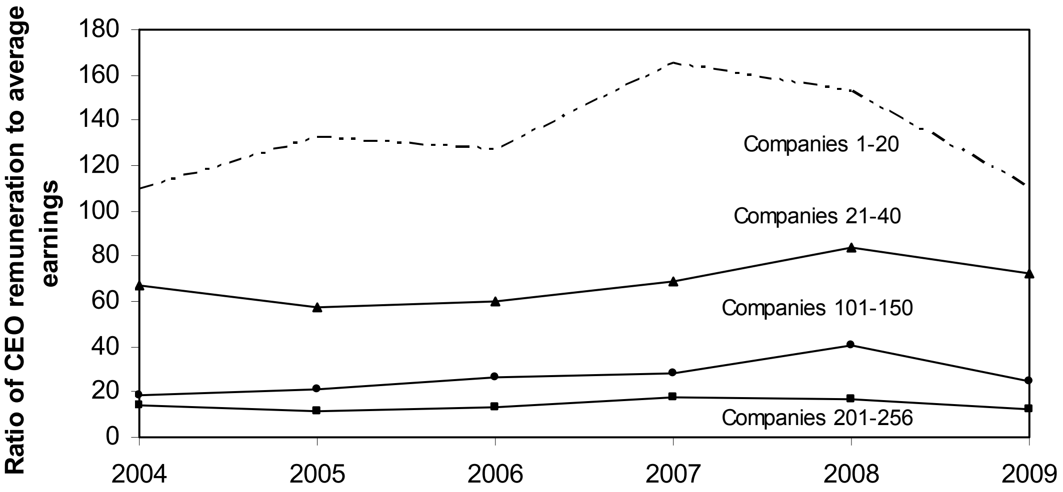
2007-08



With growth rates for executive remuneration exceeding growth in average weekly earnings for nearly two decades, the gap between them widened, especially for the largest companies (figure 3). However, since 2006-07 the gap has narrowed somewhat, returning to levels observed between 2004 and 2006.

Nearly all of the growth in reported CEO pay for the top 300 companies in the years preceding the GFC was attributable to increases in incentive pay (as valued for accounting purposes), especially 'long-term' incentives, which tripled between 2004 and 2007. The extent to which there was any initial trade-off with base pay (cash-in-hand) or other unreported rewards such as fringe benefits is unclear, though average base pay has declined somewhat in real terms in more recent years. Since 2007, long-term incentives (LTIs) have fallen by around 25 per cent and the decline in short-term incentives (STIs) ('bonuses') has been even greater.

Figure 3 **Earnings multiples vary with company size**



Why has executive pay grown so strongly?

There have been a number of drivers of executive pay in Australia over the past 20 years, some of which relate to demand and supply pressures and developments, while others revolve around corporate governance and the implementation of incentive pay structures intended to address principal–agent issues.

Globalisation, increased company size and competition for top talent

Liberalisation of Australia's product and financial markets together with the introduction of competition in many formerly government-controlled sectors in the 1980s and 1990s, drove substantial domestic structural change, including corporate consolidation and the emergence of internationally-competitive companies with global operations. Today, for example, BHP Billiton (Australia's largest listed company) has a market capitalisation of some $200 billion, compared to $16 billion in 1989 at the end of the high protection era. Wesfarmers' capitalisation increased from $800 million to around $26 billion over the same period.

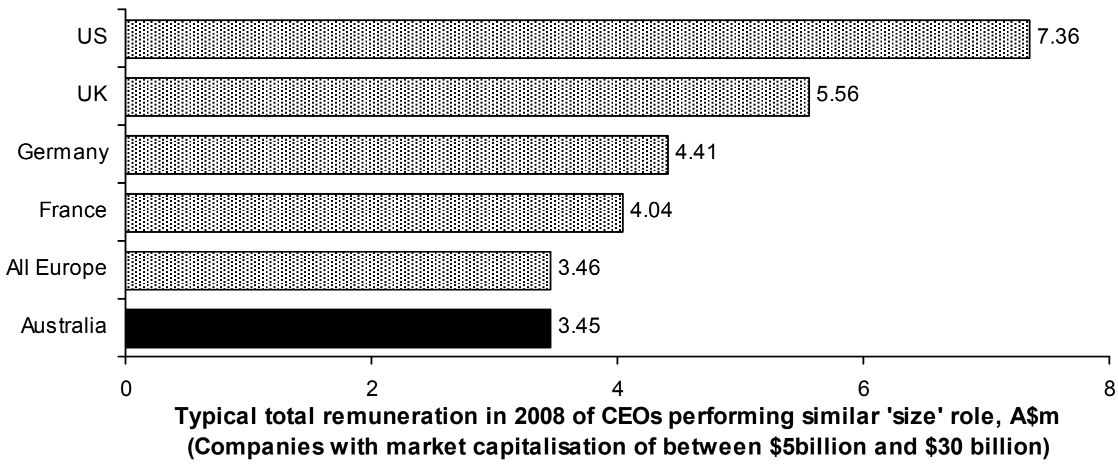
The pay-offs for these and other large companies operating in competitive markets from having a highly-talented CEO and senior executives (and the losses from having inferior ones) are potentially commensurately large. In line with their global focus, many companies now demand candidates with international experience. At the same time, Australian (and other) executives have become more mobile across companies and internationally.

While Australian data constrain the scope for long-term time series analysis, the results of a simple regression analysis of the effect of changes in company size on changes in Australian CEO pay for the 2000s accord with overseas and local research — a 10 per cent increase in company size seems to be associated with around a 4 per cent increase in CEO pay. This same relationship (with opposite sign) can be observed during the recent decline in market capitalisation. While the relationship is not present precisely for every company, broadly speaking, bigger companies seem to be prepared to pay more — both to compensate for increased job importance and complexity and to attract the most talented people. In sum, company size seems to explain 25–50 per cent of observed increases in executive pay.

The increased mobility of executives, coupled with the very high levels of executive pay in the United States (which is the outlier globally), has also had flow-on effects to Australia — for example, through the 'importation' of a few high profile US executives to key CEO positions in the early 1990s. These appointments essentially introduced US-style incentive-based remuneration structures to Australia, although such a trend was probably inevitable.

Since then, a number of CEOs have been recruited abroad (for example, 5 of 28 new CEOs for the top 50 companies between 2003 and 2007). That said, Australian executive remuneration levels generally remain below those in the United States and the United Kingdom, being more in line with smaller European economies (figure 4).

Figure 4 **CEO remuneration is closer to the European average**



This could reflect non-pecuniary benefits or lower costs of living in Australia, or for US CEOs, the much higher share of at-risk pay (which commands a risk premium).

It could also indicate that US pay has become distorted, and that Australian companies simply do not consider candidates who command such rates.

There is some evidence that remuneration of CEOs in the Australian finance sector is closer to US pay levels (for similar sized banks), possibly reflecting higher mobility and global integration in that sector and the dominance of New York and London.

Did enhanced disclosure trigger pay ratcheting?

Since 1998, individual disclosure of the remuneration of the top executive earners in all listed companies has been required. (Before then, executive pay was reported by pay 'band'.) Some participants argued that public disclosure of individuals' pay triggered a pay spiral, as companies and executives sought to 'position' themselves in the market, with no one wishing to be seen as hiring or being a 'below average' executive. This is sometimes characterised as the 'Lake Wobegon' effect — a mythical place from US public radio where '… all the children are above average'.

But there is no clear evidence of an acceleration in the growth of executive remuneration in aggregate following introduction of the new disclosure rules. Indeed, the rate of increase in pay slowed in the 2000s compared to the late 1990s. The reversal in executive remuneration since 2007 also indicates that not all companies are locked into providing above average remuneration.

Nonetheless, by improving access to market comparator information for both executives and boards, public disclosure is likely to have led to more rapid flow-on effects where, for example, one company in an industry disturbs relativities by paying an overseas appointee a significantly higher level of remuneration.

More pay for improved performance, or just more pay?

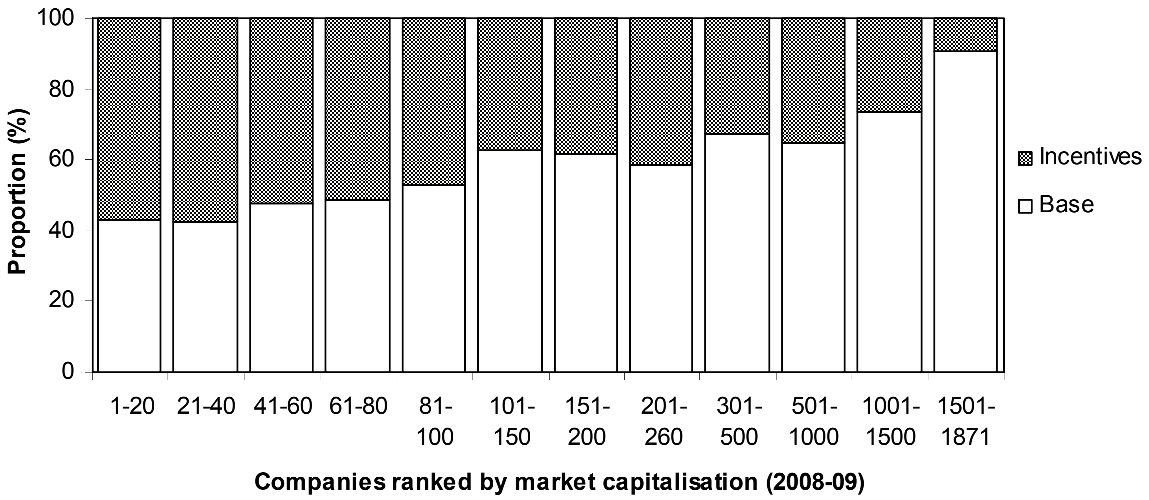
Since the 1990s, the composition of remuneration for senior executives in Australia has changed fundamentally, with a greater focus being placed by boards (and shareholders) on equity-based remuneration, such as options and ordinary company shares (LTIs), and other performance-based forms of remuneration, such as short-term bonuses (STIs) (table 1).

Table 1 **The increasing share of incentive pay in total pay (%)**

	CEOs			Non-CEO executives		
ASX300	*Base*	*STI*	*LTI*	*Base*	*STI*	*LTI*
2003-04	59	30	11	67	23	10
2006-07	40	34	26	45	32	23
2007-08	43	29	28	45	29	27
2008-09	50	25	25	57	21	22

Granting performance-based pay can make sense for companies, because it has the potential to reduce the 'agency costs' that would result from executives being paid fixed cash amounts regardless. Agency costs include the costs of executives putting their efforts into decisions that promote their own interests and agendas, but are not in the best interests of the company, as well as the costs incurred monitoring them to make sure this does not happen. As these costs tend to be higher for larger companies (because of more dispersed ownership and the potentially greater influence of executives over company assets), they might be expected to rely more heavily on incentive pay, and the data lend broad support to this (figure 5).

Figure 5 **Incentive pay is proportionately bigger for bigger companies**



Incentive pay will generally involve greater monetary cost for companies than fixed pay, because of the additional risks for the executive (box 1). In principle, boards will be prepared to pay executives a risk premium *if* they consider that the associated incentives (at least) improve company performance commensurately over time. In this sense, incentive pay can be a positive sum game, with rewards accruing to both the executive and shareholders.

However, while greater use of incentive pay has almost certainly led to higher reported pay over time, in practice, it might not have translated to improved company performance. Compliant boards, or the difficulties posed for them by very complex incentive pay arrangements, could allow executives to mould performance measures and hurdles in their favour, so that ‘at risk’ pay becomes a virtual certainty, perhaps even rewarding and encouraging poor performance. (This is popularly known as the managerial power hypothesis — box 2.)

Box 1 **Riskier pay requires a risk premium**

Incentive pay can promote alignment of managerial and shareholder interests. However, from the perspective of executives it:

- introduces uncertainty about the level of remuneration eventually received (because performance hurdles are not trivial or are susceptible to forces outside their control)
- can constrain their ability to diversify their wealth, exposing them to portfolio risk

Thus, executives will require a ‘risk premium’ compared to a fixed cash salary. The premium required will vary with the risk aversion of the executive and the uncertainties attached to the particular pay hurdles and share price volatility for different companies.

Box 2 **The essential conditions for ‘managerial power’**

According to Bebchuk and Fried, US executives dominate boards to such a degree they effectively set their own pay, subject only to so-called ‘outrage’ costs and constraints, that is, negative reaction by shareholders, the business media and others which can lead to reputational embarrassment.

In their view, executives (and compliant boards) have ‘camouflaged’ remuneration arrangements to limit external scrutiny of rising pay, using complex and hidden vehicles such as options, termination pay and company loans, that are not linked to performance hurdles. Camouflage is more likely where:

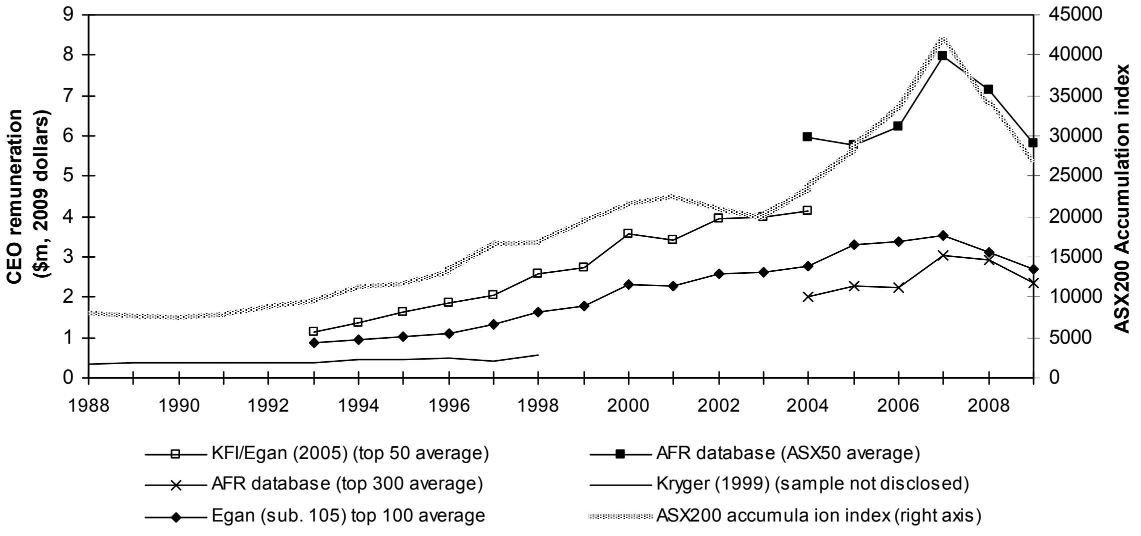
- boards are not ‘independent’ or procedures for setting pay are conflicted (and therefore susceptible to CEO influence)
- boards do not have the competencies to fully understand complex pay instruments
- there is limited remuneration disclosure and limited scope for shareholders to voice their (dis)approval.

Has executive pay been 'efficient'?

It has not been possible to ascertain conclusively whether executive pay in Australia has been appropriately set by boards. On the one hand, there are various indicators in favour:

- There has been a strong correlation between pay and company performance in aggregate, both in good times and bad (figure 6).
  - Demonstrating this relationship at a more disaggregated level has proved difficult in the absence of detailed information about performance targets, the extent of executives' total 'skin in the game', their risk preferences and the level of pay risk
- Options (which can deliver large returns in rising markets) and hidden company loans have not been widely adopted in Australia compared to the United States, and long-term incentive hurdles (at least since the early to mid 2000s) have been increasingly linked to shareholder return relative to comparable companies, constraining excessive rewards for 'good luck'.

Figure 6 **Executive pay has tracked the accumulation index**



- On a range of indicators, the boards of larger Australian companies appear to be relatively independent, with many adopting procedures (including remuneration committees) that would be expected to reduce the potential for senior executives to directly influence the setting of their own pay (box 3).

- Australian boards have also been made increasingly accountable on remuneration matters through disclosure requirements and the (non-binding) shareholder vote on the remuneration report — which Bebchuk, for example, considers should be introduced in the United States to 'move pay arrangements toward those that best serve shareholder interests'.

Box 3 **Australia's corporate governance rates well**

- Australian boards are generally smaller than US boards, with few dual CEO/chairs (particularly for larger companies), and a higher proportion of non-executive directors (NEDs) and 'independents'. Independent NEDs comprise a majority of most ASX300 company boards.
- Most large Australian companies have remuneration committees.
  - Around 75 per cent of remuneration committees in larger companies comprise only NEDs, and most remuneration committees in the top 400 companies comprise mainly *independent* NEDs, and have an independent chair.
- Each year listed companies must produce a remuneration report with pay details for top executives. Shareholders have a non-binding vote on this report.

The World Economic Forum has consistently ranked Australia in the top three countries for corporate governance since 2002-03. GovernanceMetrics International (2008) ranked corporate governance in top Australian companies fourth of 38 countries.

On the other hand, there are some reasons for having doubts:

- Not all public companies meet best practice guidelines for remuneration setting. While many of these are at the smaller end of the scale, a significant minority of remuneration committees of large companies include an executive member, and might also receive remuneration advice from consultants who undertake other work for the CEO, or who might not report directly to the board.
- Some very large termination payments appear difficult to reconcile with company and shareholder interests.
- Incentive pay invariably is challenging to design and seems to have been introduced in the 1990s without adequate understanding by some boards, with 'permissive' hurdles delivering strong pay growth in that decade (box 4).

Box 4 **Incentive pay: more art than science?**

Incentive pay typically comprises:

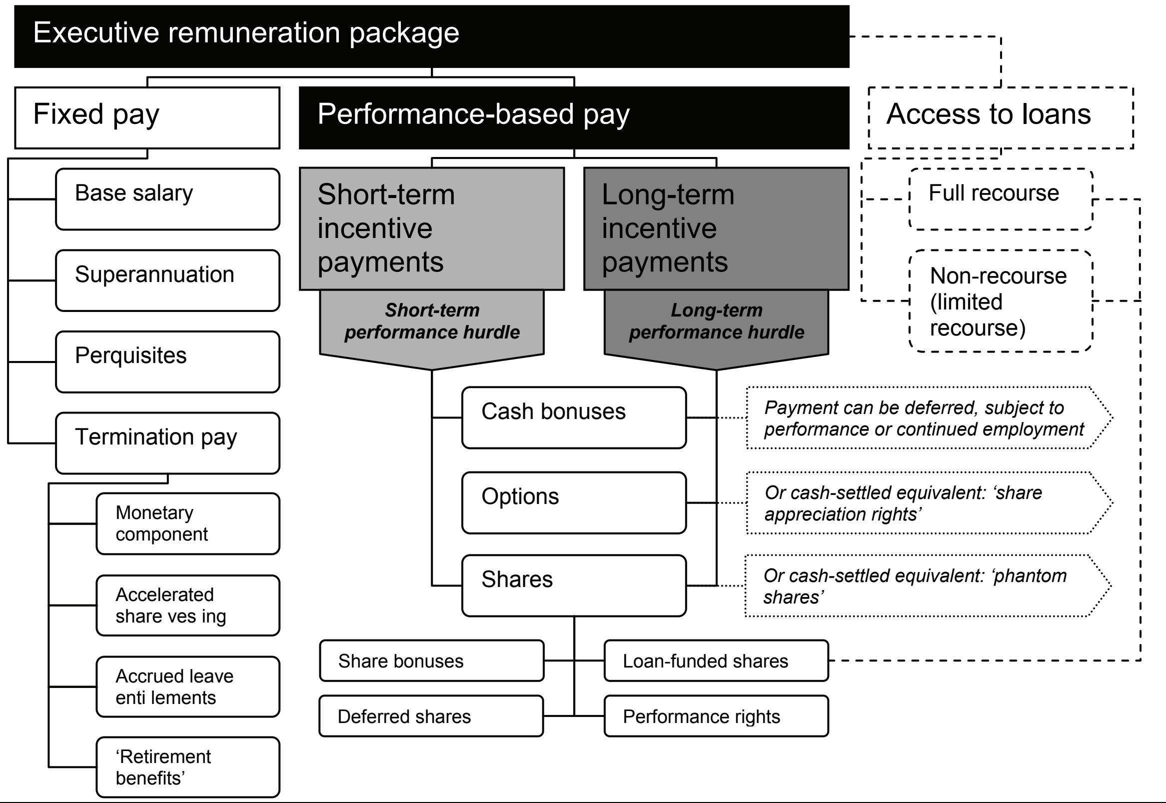
- paying executives shares or options with holding requirements. Equity directly links some of the executive's wealth to the share price (and dividends) of the company.
- awarding remuneration (cash, options or equity) when performance hurdles are met in the short term (generally one year) or long term (around three years). Short-term hurdles often relate to a company's financial performance, OH&S outcomes or business strategy implementation, whereas long-term hurdles usually relate to broader market metrics such as total shareholder return.

'Ideal' remuneration structures vary because risk preferences vary across companies and individuals. Start-up ventures are likely to have a greater risk tolerance than established companies. Some executives prefer greater certainty in remuneration and will be willing to trade off upside rewards for less downside risk.

The various pay forms and hurdles (and combinations of them) have different incentive effects. Options provide more (possibly excessive) 'upside' incentive than shares, but little downside risk. Once 'under water', they provide little incentive to drive an incremental increase in share price. Large equity holdings can promote alignment yet might make executives risk averse (especially as they approach retirement).

- The complexity of some incentive pay arrangements in more recent times (figure 7) could have allowed unanticipated upside (especially during the share market boom prior to 2007-08), yet weakened or distorted the incentive effects for executives.
  - Short-term incentives linked to inappropriate performance metrics in the finance industry in some instances encouraged excessive risk-taking, although they appear to have been far less pervasive in Australia than overseas. Such practices are the focus of the Australian Prudential Regulation Authority's new remuneration guidelines.
  - The Commission understands that executives view some complicated long-term incentives linked to share market performance as akin to a lottery, such that they have little (positive or negative) incentive effect, yet could end up delivering large payments to the executive at large cost to the company.

Figure 7 **Executive pay is multi-dimensional**



Strong corporate governance is the key

As noted at the outset, the prime motivation for this inquiry is a widespread perception that executives have been rewarded for failure or simply good luck. And certainly in some periods and for some CEOs, pay outcomes appear inconsistent with a reasonably efficient executive labour market.

While the direct consequences of these for aggregate economic efficiency in the Australian context might not have been large (representing in most cases a profit transfer from shareholders to executives), instances of 'excessive' pay tied to perverse incentives could have weakened company performance. Executive remuneration outcomes also provide a window on board performance more broadly, with apparent board 'failure' fomenting disquiet among investors and the community more broadly, potentially sapping confidence and trust in equity markets.

Particularly at a time of sharemarket weakness, such disquiet has been fuelled by well-publicised examples of seemingly egregious pay outcomes, and can lead to other companies being tarred with the same brush. This should make all Australian companies concerned about good governance and community perceptions of their conduct.

But having examined a number of alternative measures proposed by participants, the Commission is convinced that the way forward is not to bypass the central role and responsibility of boards in remuneration-setting, especially through prescriptive regulatory measures such as mandated pay caps.

- Although they might superficially address concerns about fairness, caps on total remuneration for executives would give rise to a number of severe practical problems, due to variations in market circumstances across companies and over time. They would also disadvantage some firms over others and have undesirable commercial consequences for Australian companies relative to their competitors.
- Caps on bonuses or other elements of pay, or tax arrangements designed to have similar constraining effects, would lead to readjustment of packages in ways that could weaken incentive alignment, but with probable negligible impact on total remuneration levels.

Furthermore, the Commission considers that a binding shareholder vote on the remuneration report would be unworkable given the report's complexity and coverage, and would compromise the board's authority to negotiate with executives. (However, reducing the trigger for termination payments to require shareholder endorsement seems on balance to be warranted, and given evidence that most companies already tie termination payments to around one year's base salary, the new legislated provisions are unlikely to have significant adverse effects, while addressing shareholder and community concerns.)

In seeking to overcome the perceived problem of captured or incompetent boards, such regulatory proposals risk 'throwing the baby out with the bathwater' and making shareholders worse off — the principal–agent 'problem' cannot be eliminated without removing the wealth-creating public company structure that creates it (box 5). The only practicable means for the many thousands of diverse shareholders of a public company to achieve a remuneration structure that promotes the company's long-term interests is for them to ensure that they have an able and properly motivated agent — the board.

Accordingly, the Commission considers that the more appropriate and proportionate response is to improve corporate governance and enhance the effectiveness and credibility of boards, as well as to make boards more accountable in relation to pay setting, taking into account the need to minimise potential costs and the scope for unintended consequences.

Box 5 The role of boards and the principal–agent problem

‘Wide’ or diverse company ownership necessitates separation of ownership from management of the company. Employing skilled, specialist managers can bring large benefits, but there is the potential for them to pursue their own objectives rather than those of the company and its shareholders. This is the principal–agent ‘problem’.

The primary mechanism for ensuring managers act in the company’s (and therefore shareholders’) interests is shareholders electing boards which have the authority for hiring and remunerating the CEO as well as for taking decisions about company strategy and profit distribution. Importantly, company boards have a fiduciary duty to act in the interests of the *company*, not shareholders per se. This distinction is deliberate — promoting the company’s interests will be in the interests of shareholders as a group over time, but is unlikely to be in the best interests of each and every shareholder all of the time. Indeed, if the board were expected to meet every shareholders’ preferences, the benefits of delegating authority to it and, hence, the benefits of the widely-held public company structure, would be largely forfeited.

Promoting communication and capabilities and minimising conflicts of interest

Australia’s regulatory framework has been progressively strengthened over time, together with industry corporate governance arrangements, balancing prescription with flexibility. There is scope to further strengthen the framework and achieve a closer alignment between the interests of executives, shareholders and the boards that represent them.

The Commission is recommending a number of reforms aimed at minimising the scope for conflicts of interest in remuneration setting and at strengthening board accountability on remuneration matters generally. Many of these complement reforms proposed by the Australian Prudential Regulation Authority for the financial sector, but with wider application.

Some of the proposals apply more strictly to larger companies than smaller ones, even though corporate governance is much closer to best practice in the former than the latter. But how well larger companies perform affects many in the community. So it is not unreasonable to expect larger companies to meet accepted best practice, while recognising the need for flexibility to accommodate the diversity of Australian companies.

Improving board accountability and capacities

Boards effectively form a bridge between management and owners. Competent and independent decision making should be their hallmarks and this implies directors having an appropriate mix of skills, knowledge and experience. Yet there are concerns that de facto ‘barriers to entry’ mean that companies are not adequately tapping into, and utilising, available talent for board membership, including women.

While resorting to mechanisms such as strict quotas would risk promoting diversity at the expense of merit and hence company performance, the Commission strongly endorses the ASX Corporate Governance Council proposal for companies to report publicly on progress in achieving their own declared targets. Greater transparency around selection of board candidates regardless of gender should also be encouraged.

An additional measure to ameliorate perceptions of a directors’ ‘club’ would be to give shareholders a say on proposals by the board to limit board vacancies. It seems appropriate that boards that wish to invoke the ‘no vacancy rule’ in relation to the election of directors explain their reasons and seek shareholder approval by way of an ordinary resolution. If that resolution were rejected, vacancies would be declared to the maximum in the company’s constitution for that annual general meeting. The board should still retain the right to appoint a director at any time throughout the year (subject to the usual confirmation at the next annual general meeting) and to fill, or leave vacant, casual vacancies at any time.

Avoiding conflicts of interest

Minimising scope for executives to influence the design of their own remuneration is fundamental to good governance and trust. The Commission accordingly proposes:

- strengthening requirements for the establishment of remuneration committees, the independence of their membership and their interaction with company executives, particularly for the top 300 companies
- requiring remuneration consultants to report directly to the board or remuneration committee (without constraining scope for them to consult with management)
- disclosure in remuneration reports of the use of remuneration consultants.

Further desirable measures would be to exclude executives and directors from voting their own shares or undirected proxies on the remuneration report and related resolutions. While these measures go beyond normal conflict-of-interest voting exclusions, the vote on the remuneration report is atypical because it is advisory only, and should aim to capture views on the report of those external to its development.

Enhanced disclosure and communication

The usefulness of remuneration reports to investors has been constrained by their length and complexity, as well as by 'boiler-plating' and some crucial omissions. There will always be tension between readability and the desire of investors and advisers for comprehensive reporting, but some changes would improve the balance:

- Plain English presentation would promote investor understanding of executive pay. Company efforts to improve the readability of their reports would be bolstered by guidance on best practice, with boards encouraged to include a discussion of their approach to remuneration setting and the variables and risks considered, as outlined below.
- Reporting of total *actual* pay would be useful to investors (to reconcile with initial estimates and expectations) as would fuller reporting of performance hurdles, taking account of commercial sensitivities. Including a summary of executives' total equity holdings in the company would also be useful (although this would duplicate material already in the annual report). While shareholdings are not remuneration, they are an important indicator of 'skin in the game' and incentive alignment, and thus an important complement to incentive pay arrangements.
- The remuneration report should be confined to 'key management personnel', with possible scope to confine detailed reporting to the CEO and other executives on the board (with information being consolidated for other key management personnel).

There also appears to be scope to streamline the architecture of disclosure requirements, with positive payoffs for readability and compliance costs. To this end, the Commission is recommending the establishment of an expert panel under the auspices of the Australian Securities and Investments Commission, to advise it on how best to revise the architecture of section 300A of the *Corporations Act 2001 (Cwlth)* and the relevant regulations to achieve recommended enhancements.

Promoting efficient incentive alignment

While there is no single 'right' pay structure for aligning incentives, investors might be reassured if boards have, for example, undertaken prudent risk assessments and sensitivity analysis in crafting incentive pay arrangements, as well as considered the scope for simpler and potentially less costly pay structures. The Commission has outlined a 'checklist' for good remuneration practice to enhance the information content of companies' remuneration reports.

Hedging by executives against company-specific risks associated with equity-based remuneration could weaken the intended link between pay and performance in remuneration packages. Although the practice appears uncommon, in line with policies of many companies, hedging of unvested equity and vested equity subject to holding locks should be prohibited.

Furthermore, scope to defer taxation of long-term equity incentives (those at risk of forfeiture) beyond departure could facilitate deferment of remuneration, thereby promoting 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.

Encouraging shareholder engagement

Despite initial scepticism by business, the non-binding vote on the remuneration report appears to have fostered more productive engagement between shareholders and boards. Most boards have proven sensitive to significant minority 'no' votes and many amend executive remuneration in anticipation or in response. Yet there are instances where companies have received significant consecutive 'no' votes on their remuneration report — in 2008 and 2009 the Commission estimates that almost 5 per cent of ASX200 companies received two consecutive no votes of 25 per cent or more. In addition, the average level of 'no' votes has been gradually increasing.

The Commission therefore sees a case for increasing shareholder leverage through the vote on the remuneration report, to target seemingly unresponsive boards in a bid to promote better dialogue between them and their shareholders. But it also recognises that any measures need to be balanced against the desirability of maintaining both the board's authority to set executive pay, and the integrity and benefits of the non-binding vote itself.

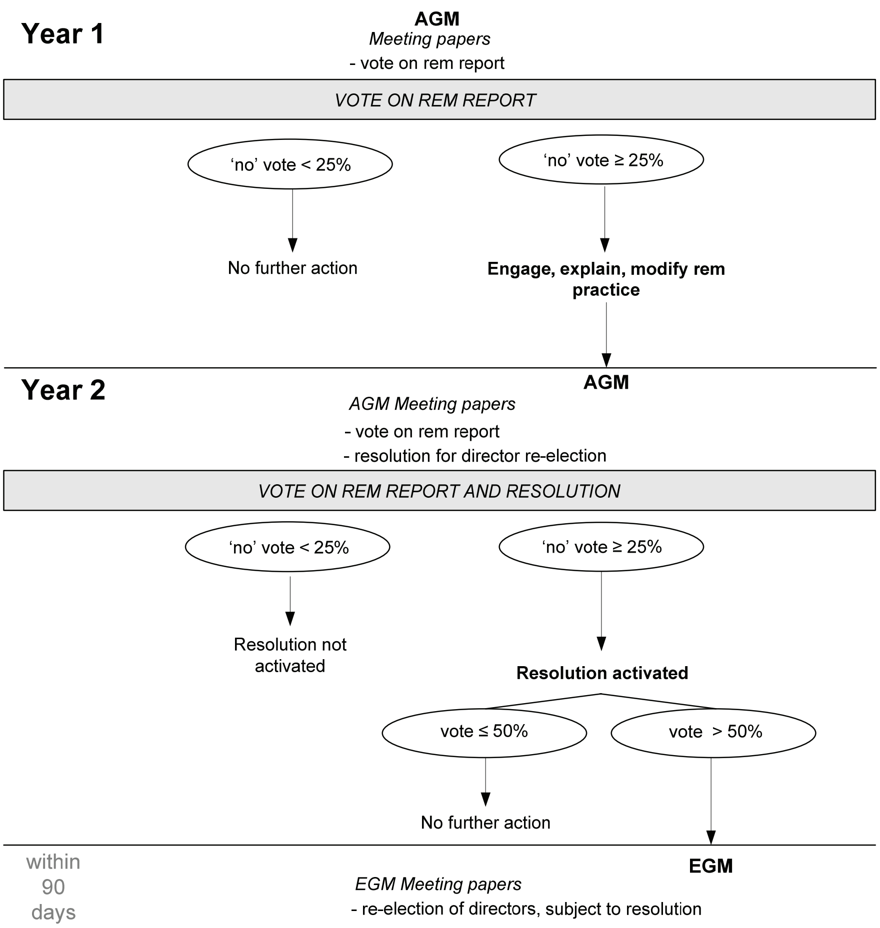
Accordingly, the Commission proposes that:

- Companies be required to explain in the remuneration report their response to a 'no' vote of 25 per cent or more the previous year. In essence, this would codify what many companies do voluntarily.

- Where there is a second consecutive vote against the remuneration report of 25 per cent or more, a separate 're-election' resolution would be put automatically at that annual general meeting (and included in voting papers circulated prior to the meeting), to the effect that all elected directors who signed the directors' report for that year face re-election at an extraordinary general meeting (to be held within 90 days). To pass, this re-election resolution would require a majority of eligible votes cast. (See figure 8)

This approach enables shareholders to voice their opinion on the remuneration report through a non-binding vote and then decide whether stronger action is required by voting on a separate re-election resolution where the board appears unresponsive to their concerns.

Figure 8 **Two-strikes plus a resolution to 'spill' the board**



Compared with a mechanism where a second substantial vote against the remuneration report automatically triggered a vote on directors, the insertion of a separate resolution for directors to face re-election would significantly reduce any downside risks for the operation of boards and stability of companies, or the willingness of shareholders to vote against a remuneration report. (Typically a high vote against a remuneration report does not translate into a vote against directors standing for re-election.) Yet the mechanism would still hold to account those boards considered deficient in relation to executive pay practices. In short, shareholders would be given control over the message they wished to send to boards, encouraging all boards to maintain a commitment to the development of well-structured pay arrangements.

A future review of the reforms

No intervention is costless or without risk. There will be compliance costs as well as more subtle behavioural consequences. The Commission accordingly 'stress tested' its proposed reforms in a Discussion Draft and has made modifications since to take account of a number of valid concerns. Nevertheless, it would be desirable for the Australian Government to conduct a review within five years into the operation, impacts and effectiveness of any reforms flowing from this report, as well as the recently-introduced changes to shareholder approval of termination payments.

Summing up

The Commission considers that, collectively, these changes would significantly strengthen corporate governance and alignment of interests — giving shareholders better information and more 'say' on pay.

In doing so, they should reduce the likelihood in future of inappropriate remuneration outcomes, especially those that shareholders would find objectionable, and help secure greater public confidence in the corporate sector. They would not, however, put an end to high pay for executives of the largest companies where warranted to secure the best people and motivate them in line with shareholders' interests.

Finally, the Commission acknowledges that its proposed reforms may require boards to pay more attention to executive remuneration than some have done in the past. In the Commission's view, this is called for and will complement rather than compete with other key board responsibilities. Appropriate remuneration structures for executives not only reflect on board competence, but are integral to the successful implementation of corporate strategies and thus the creation of shareholder wealth.

The recommendations at a glance

Recommendation	*Targeted benefits*
Board capacities	
1. Any declaration of 'no vacancy' at an AGM to be agreed to by shareholders.	• Increases shareholder's input on board size and composition and addresses perceptions of a 'directors' club'.
Finding 1: *Support an 'if not, why not' requirement for boards to report progress against gender objectives.*	• Encourages boards to draw more widely from the available talent pool.
Conflicts of interest	
2. On an 'if not why not' basis: • remuneration committees to comprise at least three members, all non-executive directors, with a majority and the chair independent • companies to have a charter setting out procedures for non-committee members attending meetings.	• Constrains executive influence on pay. • Promotes best practice for all listed companies.
3. For ASX300 companies, executives to be prohibited from sitting on remuneration committees. (Listing rule)	• Constrains executive influence on pay. • Aligns with APRA initiative for finance sector and targets companies able to meet compliance cost.
4. Prohibit executives and directors voting their own shares on remuneration reports.	• Increases shareholder signal on non-binding vote.
5. Prohibit executives hedging unvested equity remuneration or vested equity subject to holding locks.	• Improves alignment between executives and shareholders. • Engenders confidence in pay practices.
6. Prohibit executives and directors voting undirected proxies on remuneration reports.	• Increases shareholder signal on non-binding vote.
7. Require proxy holders to cast all their directed proxies on remuneration reports.	• Increases shareholder signal on non-binding vote.
Disclosure	
8. Improve information content and accessibility of remuneration reports through: • a plain English summary of remuneration policies • reporting actual remuneration received and total company shareholdings of individuals in the report. • Expert panel to advise on revised Corporations Act architecture to support changes.	• Better informed shareholders. • Reduced confusion (and misreporting) about pay structures. • Enhanced engagement between boards and shareholders.
9. Remuneration disclosures to be confined to key management personnel.	• Aligns Act with accounting standards. • Reduces compliance costs. • Improves readability.

(Continued next page)

The recommendations at a glance (continued)

Recommendation	*Targeted benefits*
10. Companies to disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company. ('If not, why not')	• Constrains executive influence on pay through transparency. • Promotes best practice for all listed companies.
11. For ASX300 companies, advisers on executive pay to be commissioned by, and their advice provided directly to, the board, independent of management. (Listing rule)	• Constrains executive influence on pay. • Aligns with APRA initiative for finance sector. • Targets companies able to meet costs.
12. Institutional investors to voluntarily disclose how they have voted on remuneration reports (and other remuneration-related issues).	• Better informed (potential) investors. • Targets agency issues, particularly for compulsory superannuation contributors.
Remuneration principles	
13. Remove cessation of employment as the taxation point for deferred equity subject to risk of forfeiture.	• Removes barrier to deferred remuneration. • Consistent with longer term alignment. • Removes need for special tax rulings.
Finding 2: Remuneration 'check list' for boards to improve information content in remuneration reports.	• Enhanced quality of disclosure. • Provides guidance to encourage and promote better remuneration practices.
Shareholder engagement	
14. Confirm allowance of electronic voting without amendment of company constitutions.	• Improves efficiency and integrity of shareholder voting. • Potential for cost savings.
15. 'Two strikes and re-election resolution': • 25 per cent 'no' vote on remuneration report triggers reporting obligation on how concerns addressed • subsequent 'no' vote of 25 per cent activates a resolution for elected directors to submit for re-election within 90 days.	• Increases shareholder signalling and power. • Increases pressure on companies to respond to shareholder concerns. • Targets unresponsive boards.
Implementation issues	
16. The Australian Government to implement intent of recommendations 2, 3, 10 and 11 by legislation if the ASX and Corporate Governance Council do not make requisite changes.	• Ensures potential benefits from recommended reforms can be achieved.
17. Review within five years to consider: • the effectiveness and efficiency of the reforms, including to termination payments and employee share schemes • the regulatory architecture.	• Evaluation of efficacy and economic impact of reforms. • Identification of any unexpected outcomes that warrant corrective action.

Recommendations and findings

Recommendations

RECOMMENDATION 1

For the election of directors at a general meeting, where the board seeks to declare no vacancies and the number of directors is less than the constitutional maximum, approval should be sought from shareholders by way of an ordinary resolution at that general meeting.

Boards would retain their powers to appoint directors and fill or leave vacant casual vacancies throughout the year.

This recommendation should be effected through amendments to the Corporations Act 2001 and relevant regulations.

RECOMMENDATION 2

The ASX Corporate Governance Council should introduce an 'if not, why not' recommendation specifying that remuneration committees:

- ***have at least three members***
- ***comprise non-executive directors, a majority of whom are independent***
- ***be chaired by an independent director***
- ***have a charter setting out procedures for non-committee members attending meetings.***

RECOMMENDATION 3

In conjunction with recommendation 2, a new ASX listing rule should specify that all ASX300 companies have a remuneration committee and that it should comprise solely non-executive directors.

RECOMMENDATION 4

The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors be prohibited from voting their shares on remuneration reports and any resolutions related to those reports.

RECOMMENDATION 5

The Corporations Act 2001 should specify that companies prohibit their executives from hedging unvested equity remuneration or vested equity subject to holding locks.

RECOMMENDATION 6

The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors from voting undirected proxies on remuneration reports and any resolutions related to those reports.

RECOMMENDATION 7

The Corporations Act 2001 should be amended to require proxy holders, except in exceptional circumstances, to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.

RECOMMENDATION 8

The usefulness of remuneration reports to investors has been diminished by their complexity and by crucial omissions. Remuneration reports should include:

- ***a plain English summary statement of companies' remuneration policies***
- ***actual levels of remuneration received by the individuals named in the report***
- ***total company shareholdings of the individuals named in the report.***

The Australian Government should establish an expert panel under the auspices of the Australian Securities and Investments Commission to advise it on how best to revise the architecture of section 300A of the Corporations Act 2001 and the relevant regulations to support these changes.

The convened expert panel should take account of the Commission's:

- detailed guidance on the requirements for recommendation 8 (see chapter 8).
- 'check list' of information which should, where relevant, be reflected in remuneration reports (section 11.5).

RECOMMENDATION 9

Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to key management personnel. The additional requirement for the disclosure of the top five executives should be removed.

RECOMMENDATION 10

The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.

RECOMMENDATION 11

The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.

RECOMMENDATION 12

Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to superannuation funds regulated under the Superannuation Industry (Supervision) Act 1993.

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.

RECOMMENDATION 14

The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

RECOMMENDATION 15

The Corporations Act 2001 should be amended such that:

- ***where a company's remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at an annual general meeting (AGM), the board be required to explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why***
- ***where the subsequent remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at the next AGM, a resolution be put that the elected directors who signed the directors' report for that meeting stand for re-election at an extraordinary general meeting (the re-election resolution). Notice of the re-election resolution would be contained in the meeting papers for that AGM. If it were carried by more than 50 per cent of eligible votes cast, the board would be required to give notice that such an extraordinary general meeting will be held within 90 days.***

Definitions and machinery

- 'Elected directors' — excludes any director not required to submit for election (managing directors) under ASX listing rules.
- 'Eligible votes cast' — directors and executives identified as key management personnel would be ineligible to vote their own shares, or undirected proxies held by them, in relation to remuneration reports or the re-election resolution. Normal voting protocols would apply to the re-election of directors.
- 'Director re-election' — if the re-election resolution is carried, all board members would continue in their positions until the EGM, at which time elected directors would present individually for re-election. The terms of appointments for re-elected directors would continue as if uninterrupted.
- Re-setting the mechanism — If the re-election resolution is activated, irrespective of whether or not it is carried, the entire process would be re-set. However, the requirement to explain how shareholder concerns were addressed in the subsequent remuneration report would stand.

RECOMMENDATION 16

If the Australian Securities Exchange does not give effect to recommendations 3 or 11 and/or the Australian Securities Exchange Corporate Governance Council does not give effect to recommendations 2 or 10, the Australian Government should give consideration to putting into effect the intent of those recommendations through legislative means.

RECOMMENDATION 17

There should be a review of the corporate governance arrangements that emanate from the Australian Government's response to this report. The review should be conducted no later than five years from the introduction of the new arrangements. In particular, the review should consider:

- ***the effectiveness and efficiency of the reforms in meeting their objectives both individually and as a package, including recent legislative reforms to termination payments and employee share schemes***
- ***any changes to the regulatory architecture that affects the operations of, or the balance of responsibilities between, the Corporations Act 2001, the Australian Securities Exchange listing rules and the Australian Securities Exchange Corporate Governance Council's principles and recommendations.***

Findings

FINDING 1

The continuing marked under-representation of women on boards indicates that boards are not drawing sufficiently widely from available talent. Given the lack of progress in addressing this, the Commission strongly endorses the initiatives by the ASX Corporate Governance Council:

- *to require companies to adopt and disclose, on an 'if not, why not' basis, their progress against gender objectives set by their boards*
- *to encourage nomination committees to review the proportion of women at all levels in the company and disclose annually the skills and diversity criteria used for board appointments.*

Outcomes should be reviewed three years after the measures have been introduced, including to determine whether the principles and recommendations should be upgraded to a listing rule by the Australian Securities Exchange.

FINDING 2

Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, some key dimensions often warrant being explained clearly to shareholders and, where appropriate, could usefully be addressed in companies' treatment of their remuneration policies in the remuneration report:

- *how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests*
- *how the mix of base pay and incentives relates to the remuneration policy*
- *how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected, and how such benchmarks have been applied*
- *how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price), and how any deferral principles and forfeiture conditions would operate*
- *whether any 'incentive-compatible' constraints or caps apply to guard against extreme outcomes from formula-based contractual obligations*
- *whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)*
- *whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order to avoid litigation*
- *whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.*

PART A

BACKGROUND AND ANALYTICAL FRAMEWORK

1 What is the inquiry about?

Key points

- Many in the community have for some time been concerned about the level and growth of executive pay, particularly relative to average wages. More recently, such concerns have been amplified by several factors, including:
  - the attribution of the global financial crisis to unrestrained corporate greed in the financial sector
  - declining shareholder wealth and rising unemployment in Australia, juxtaposed with conspicuously large executive pay and 'golden parachute' outcomes
  - the decision by Pacific Brands — a company in receipt of taxpayer funds — to move its manufacturing operations offshore after appointing a new CEO.
- Some participants argued that egregious executive pay outcomes are evidence of systemic failure; others contended that current arrangements generally work well and that inappropriate pay practices are the exception.
  - Nevertheless, if community concern about executive remuneration were reflected in a lack of trust in corporate governance, there may be ramifications for the corporate sector generally and the wider economy.
  - Similarly, poorly designed remuneration arrangements that lead to inappropriate risk taking and short-term behaviour, particularly in the finance sector, can also have wider economic impacts.
- In line with the Commission's terms of reference, and reflecting its economy-wide perspective, this report:
  - seeks to establish the facts about what has happened to executive remuneration (to the extent that data limitations permit), and the significance of different drivers
  - assesses the effectiveness of the existing regulatory and governance framework
  - makes recommendations designed to promote better alignment between the interests of companies and shareholders, and to achieve improved outcomes for the community.

1.1 Background to the inquiry

How much executives are paid has long been a matter of considerable community interest.

The Business Council of Australia (BCA) remarked in 2004:

> Rarely a week goes by without some commentary on CEO pay. Debate inevitably focuses on excessive amounts and comparisons with the pay of average wage and salary earners. (2004a, p. 1)

The BCA's public opinion polling has found that most respondents believed that executives were overpaid. It has also revealed limited understanding about the drivers of executive pay and the concept of wealth creation (BCA 2004a).

A range of groups, including unions, social researchers and media commentators, have for some time expressed concern that the level and growth of executive pay is out of step with average wages, widening the gap between executives and other employees. In buoyant economic times, the extent to which this is an issue for the community tends to wax and wane, but concern can be galvanised quickly by events such as a corporate failure, the high profile appointment of a chief executive officer (CEO) from overseas and most recently, by the immediate aftermath of the global financial crisis.

Although the financial crisis can be traced to multiple origins (see for example, the FSA 2009b, Gruen 2009, and the IMF 2009, as well as box 1.5), of relevance for this inquiry is a view that executive pay practices encouraged excessive risk-taking in the financial sector. In announcing the inquiry, Ministers stated that 'unrestrained greed in the financial sector has led to the biggest global recession since World War II' (Swan and Sherry 2009a, p. 1).

As the financial crisis struck national economies, scrutiny of corporate performance increased. While company values and shareholder returns were falling, executive pay seemed to be unaffected. In the United States and Europe, it was widely publicised that as taxpayers were called on to bail out ailing companies, executives were receiving bonuses and generous termination packages — instances attracting worldwide attention included the US insurance company AIG and, in the United Kingdom, the Royal Bank of Scotland.

In the public eye, these outcomes have come together in a narrative about:

- executive greed and mismanagement, especially of risk, causing the financial crisis
- taxpayers subject to an erosion of their living standards seeing public funds diverted to bail out failed companies
- executives placing their remuneration above shareholder and company employee interests (including some exiting with large termination packages).

Unlike other economies, however, Australia's prudential regulatory framework has stood up well. Many contend that the 'stress-testing' of that framework has shown it to be world's best practice — there have been no collapses of major banking institutions or iconic manufacturers.

Nevertheless, there have been several widely publicised and seemingly egregious pay and termination outcomes locally, which have triggered a strong reaction from many in the community. Many Australians are shareholders — either in their own right or indirectly through superannuation contributions — and negative returns on these investments do not sit well with perceptions about burgeoning executive pay. Added to this volatile mix was the decision by Pacific Brands, a domestic company in receipt of taxpayer support, to relocate its manufacturing operations offshore. The circumstances surrounding this decision triggered a considerable community backlash and a sharp political response, culminating in this inquiry (box 1.1).

The depth of community concern was reflected in the joint Ministers' press conference announcing this inquiry, where expressions such as 'greed' and 'obscene' were used. The Government declared that it was 'determined to ensure regulation of executive pay keeps pace with community expectations' (Swan and Sherry 2009a). Reinforcing this point, it simultaneously announced that it would reduce the shareholder voting threshold for any termination payments from seven years total remuneration to one year's base pay.

Some participants have argued that executive pay outcomes demonstrate systemic failure and a need for strong regulatory measures, such as caps or restrictions on tax deductibility. Others have argued that current arrangements — in which boards have the responsibility to set pay within corporate governance and reporting frameworks — on the whole work well.

Even those who contend that the current arrangements are working well often see scope for improvement, and some have pointed to instances of poor remuneration practice — typically termination payments that appear unrelated to performance (box 1.2). The fact that the same examples are generally cited from both perspectives (for example, Toll, Oxiana, Transurban, AGL Energy, and Babcock and Brown) raises questions about whether these are symptomatic of more pervasive failures or represent exceptions or outliers. The Australian Human Resources Institute stated that:

> … the last 10 or 15 years has seen enormous pay [growth] in top executive pay, and not unrelated to growth in the size, the market capitalisation of large companies, and globalisation. But there have been excesses, nobody can deny that … a number of things we've seen happen would stretch any reasonable standard of the community acceptance … But we do remark that most of those excesses occurred offshore. There have been some in Australia but relatively few. (trans., pp. 129–30)

Even if such outcomes are not the norm, they may have shaped the community's view of corporate decision-making arrangements and practices more broadly.

Box 1.1 **Pacific Brands triggers public 'outrage'**

In late February 2009, Pacific Brands announced that it would relocate its manufacturing operations offshore, resulting in the loss of around 1800 jobs. It was widely reported that the decision coincided with sharp increases in remuneration for the company's executives. The Government reacted quickly, with the Treasurer noting:

> … the workers are right to be absolutely furious with their management, and certainly their management has got a lot of explaining to do. … to see that a privileged few are doing so well at a time when thousands of workers are being retrenched is frankly sickening. (Swan, W. 2009, p. 1)

Within a week, Pacific Brands' receipt of taxpayer support under textiles, clothing and footwear assistance arrangements was under scrutiny. The Prime Minister noted:

> … what Pacific Brands has done is … in so many respects, beyond the pale. In terms of the monies that they've got from the Government, we'll go through all of that in terms of what can be extracted back from them. (Rudd 2009, p. 6)

When this inquiry was announced at a joint Ministers' press conference on 18 March, the Treasurer referred to:

> … significant community concern about excessive pay practices, particularly at a time when many Australian families are being hit by the global recession. (Swan and Sherry 2009a, p. 1)

The Minister for Superannuation and Corporate Governance cited Pacific Brands:

> … it's been brought to our attention that the CEO of Pacific Brands left the company with a golden handshake of $3.4 million. (Swan and Sherry 2009b, p. 2)

As RiskMetrics noted, community outrage can be very influential:

> … the effectiveness of the outrage constraints are probably sharper now. Look no further than Pacific Brands … that sent a signal to a lot of boards that your brand may actually be at risk where you are mismanaging … perceptions around executive pay. (trans., p. 363)

RiskMetrics also observed that the newly appointed CEO was 'treated unfairly' (trans., p. 363) as her reported pay increase actually reflected a promotion from a divisional general manager to CEO — at less pay than the outgoing CEO.

Pacific Brands' 2009 annual report estimates a total remuneration package of around $1.07m for the CEO in the 2009 financial year, down from the corresponding 2008 value of around $1.86m (Pacific Brands 2009).

In the most recent reporting season, Qantas' payout to former CEO Geoff Dixon attracted a significant amount of media attention (ABC 2009b, Creedy 2009). Dixon's total reported remuneration in 2008-09 was almost $11 million, part of which comprised a contentious superannuation payment that related to changes in superannuation tax laws. Qantas' remuneration report subsequently attracted a significant 'no' vote in the latest reporting season, as did some other companies, such as Downer EDI and Transurban. (See chapter nine for further detail on companies that recorded significant votes against their remuneration reports in the 2009 reporting season.)

Box 1.2 **Questionable remuneration outcomes**

The Government responded to community concerns about contentious termination payments by lowering the threshold at which such payments must be approved by shareholders. In announcing the reform, the Minister for Superannuation and Corporate Law singled out two cases:

> In 2008, Owen Hegarty of Oz Minerals received a bonus of $8.35 million, which was 642 per cent of his base salary. … Consolidated Media, John Alexander in 2008 received [a] $15 million golden parachute, 468 per cent of his salary. (Swan and Sherry 2009b, p. 3)

Various participants identified other instances of large termination payments. In its submission to this inquiry, Regnan provided the following case studies:

Oxiana

> '… Owen Hegarty engineered a merger of Oxiana with Zinifex which was very unpopular with shareholders and widely commented on as destroying shareholder value. Upon his retirement the Oxiana board proposed a $10.6 million termination payment to shareholders under obligation from legislation (due to the size of the payout), which shareholders rejected.
>
> Later, the board of the new company, Oz Minerals, elected to award Owen Hegarty a slightly smaller termination payment of $8.35 million which was not large enough to trigger a shareholder vote … Oxiana's share price has since fallen from $2.63 at Owen Hegarty's retirement on 20th June 2008, to $0.60 as at 12th March 2009'. (sub. 72, p. 18)

Transurban

> 'As the outgoing Chief Executive of Transurban Group retiring on 4th April 2008, Kim Edwards received $16 million remuneration in his final year including a $5.2 million termination payment. Two months later under a new Chief Executive, the company announced that the previous shareholder distributions of 58c were 'substantially in excess of operating cash flow per security'. A capital raising, a halving of future distributions and a cost reduction program were subsequently announced. The stock price now sits at $3.91 as at 12th March 2009, relative to $6.60 on Kim Edwards' day of retirement'. (sub. 72, p. 16)

AGL Energy

> 'Paul Anthony experienced very high levels of remuneration during an 18 month tenure at AGL Energy preceding and following its listing on 12th October 2006. As part of sign-on, Paul Anthony received $1.64 million cash and approximately $4.7 million of AGL Energy shares held in escrow for two years. In addition, he received a $1.56 million cash bonus during his first year of tenure. However on the 15th October 2007 AGL Energy issued a substantial profit downgrade, followed shortly by Paul Anthony's resignation on 22nd October 2007. Over the space of ten days from the profit downgrade to Paul Anthony's resignation, AGL Energy shares lost 17.4% of their value. Almost 12 months after Paul Anthony's resignation, shareholders learned via the FY08 Annual Report released in September 2008 that a termination payment of $5.1 million had been paid'. (sub. 72, p. 21)

1.2 The Commission's task

The Commission has been asked to report on the framework and structures around the remuneration of directors and executives in companies that are disclosing entities regulated under the *Corporations Act 2001* (Cwlth). The terms of reference ask it to consider:

- trends in remuneration in Australia and internationally, including the relationship between types of remuneration and corporate performance
- the effectiveness of the framework for remuneration practices, including disclosure and reporting, and the role of boards, executives, shareholders and other stakeholders
- the role of large local institutional shareholders (such as superannuation funds)
- mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community
- the effectiveness and applicability to Australia of the international responses to remuneration issues arising from the global financial crisis.

The Commission was asked to make recommendations on how the existing 'framework' governing remuneration practices in Australia could be strengthened.

The Commission was required to liaise with the Review of Australia's Future Tax System and the Australian Prudential Regulation Authority (APRA) in relation to extensions to governance within APRA-regulated institutions. (The full terms of reference are reproduced at the front of this report.)

Scope of the inquiry

This inquiry focuses on an examination of executive pay practices for companies that are disclosing entities under the Corporations Act (box 1.3) — in essence Australia's 2000 or so publicly-listed companies. Outside the scope of the inquiry, therefore, are non-listed companies (including foreign multinational corporations and privately owned companies[1]) and the professions (such as legal and accounting firms). Some key terms and definitions are outlined in box 1.4.

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[1] A survey of private companies (220 responses) found the proportion of respondents with annual turnover of less than \$20 million was around 37 per cent. Around 29 per cent had turnover of over \$100 million, including 7.5 per cent with turnover greater than \$400 million (KPMG 2009a).

Box 1.3 Disclosing entities

Under the Corporations Act, unless specifically exempted, a body is a 'disclosing entity' if it has enhanced disclosure securities. Enhanced disclosure securities encompass arrangements where:

- securities have been issued following the release of some form of product disclosure document (typically a prospectus)
- securities have been issued and 100 or more persons hold the securities.

Consequently, disclosing entities generally:

- include listed companies and managed investment schemes (trusts)
- include unlisted companies that have issued debentures (a class of fixed interest security)
- exclude private companies, foreign multinational corporations, sole traders and partnerships.

The framework for the regulation of executive remuneration and corporate governance as a whole is built around a mix of 'black letter' law, 'soft' law and guidelines:

- 'Black letter' law includes the Corporations Act and Australian Securities Exchange (ASX) listing rules that provide sanctions for non-compliance.
- The ASX Corporate Governance Council's principles and recommendations provide an industry-wide framework of corporate governance 'soft' law for listed companies and their investors. Compliance is not mandatory, but disclosure about whether the recommendations have been complied with is required. Where a company has chosen not to comply it is obliged to explain — the 'comply or explain', or 'if not, why not' rule.
- Non-regulatory guidelines are issued by a range of organisations, including the Australian Council of Super Investors, the Australian Institute of Company Directors and the Australian Shareholders' Association.

The regulatory framework is described in detail in chapter 5.

Box 1.4 **Companies: key terms and definitions**

The entities …

A listed company can offer shares for sale to the public and the liability of shareholders for the company's debts is limited (chapter 2).

the people …

Shareholders buy a stake in a company with a right to share in profits through dividends (and may secure a capital gain if share values increase).

Executives are not defined in the Corporations Act, but can be taken to include senior management (for example, CEOs, managing directors and company secretaries).

Key management personnel are defined, in accordance with accounting standards, as 'persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity'.

Directors supervise company management collectively as a *board* and have a fiduciary duty to act in the interests of the company. The board appoints the CEO and other senior executives.

Executive directors — as opposed to *non-executive directors* — are company employees (typically a senior executive) as well as being board members.

their pay structures …

Executive remuneration may be made up of the following:

- *Base pay/salary*: usually cash remuneration, including superannuation.
- *Short-term incentives*: typically annual cash bonuses linked to performance hurdles.
- *Long-term incentives*: such as shares/stock options linked to performance hurdles.
- *Non-recourse loans*: typically take the form of interest-free loans for executives to purchase shares in the company. The company has a claim to the shares purchased, but the executive is not required to discharge the loan.
- *Termination payments*: (or 'golden parachutes') made when employment ceases.

Non-executive director remuneration typically involves a simple fee structure drawn from a 'fee pool' which is subject to shareholder approval. The ASX Corporate Governance Council guidelines state that directors should not receive options, bonus payments, or retirement benefits (other than superannuation).

and their pay disclosure.

The *remuneration report*, as required under the Corporations Act, discloses information about a company's key management personnel and the five most highly remunerated group and company executives (if different).

APRA review of executive remuneration and risk taking

APRA has been developing a framework for executive remuneration for authorised deposit-taking institutions and general and life insurance institutions. It released a consultation package in late May, followed by an additional consultation package in September, and released its final prudential requirements for remuneration on 30 November 2009.

APRA has proposed a number of modifications to governance standards to reflect the principles of 'sound compensation practices' for significant financial institutions outlined by the Financial Stability Forum in April 2009 (FSF 2009). The Financial Stability Forum's recommendations on remuneration practices aim to curtail incentives for excessive risk-taking. They include requirements that: compensation be adjusted for all types of risk; institutions disclose clear, comprehensive and timely information about their compensation practices; and directors engaged in financial and risk control be independent.

APRA's focus is on the structure, rather than quantum, of executive pay. It views boards of directors as ultimately responsible for remuneration matters. However, it proposes extensions to governance standards to require boards to establish a remuneration committee and establish, maintain, and periodically review a written remuneration policy.

APRA (2009d) has stated that its final standards will come into effect on 1 April 2010. By this date, APRA-regulated institutions will be required to have a board remuneration committee in place, as well as a remuneration policy.

An issue for this inquiry, therefore, is the potential applicability of APRA's framework — in part or in whole — beyond authorised deposit-taking institutions and the insurance sector.

Review of Australia's Taxation System

The terms of reference for the review, chaired by Treasury Secretary Ken Henry, require it to consider issues such as:

- the appropriate balance between taxing the returns from work, investment and savings, consumption (with the exception of the GST), and the role played by environmental taxes
- improvements to the tax and transfer system for individuals and families
- enhancing the taxation of savings, assets and investment, including company taxation

- simplifying the tax system (Treasury 2009a).

The review has issued a number of discussion papers, with its final report due in December 2009.

Taxation arrangements for executive remuneration fall within the scope of the Henry Review, but may not be a broad area of focus. In contrast, how tax arrangements influence the composition and structure of executive remuneration and interact with measures to align executive and shareholder interests is an important element of the Commission's inquiry (and also APRA's review). Whether recent changes to the tax treatment of share and option schemes, for example, militate against the use of long-term vesting for equity-based payments is one such taxation issue (see chapter 10).

On 21 October 2009, the Government introduced legislation into Parliament to reform taxation arrangements for employee share schemes retrospectively from 1 July 2009. As part of these changes, the Board of Taxation is undertaking work on the valuation of employee share scheme options and taxation arrangements for employee share scheme equity provided by start-up, research and development, and speculative companies. It is due to report by February 2010 (Board of Taxation 2009).

1.3 The Commission's approach

The Commission's approach to examining arrangements for the remuneration of directors and executives is ultimately directed at improving outcomes for the community. The Commission's enabling legislation directs it to 'have regard to the need to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community' (*Productivity Commission Act 1998* (Cwlth), s. 8(1)(a)). This is consistent with an emphasis in the terms of reference on securing better outcomes for shareholders and the wider community.

The key stages of the Commission's approach have been to:

1. identify (policy-relevant) problems and why individuals and markets may fail to adequately promote community wellbeing of their own accord
2. evaluate the performance of existing institutional and regulatory arrangements, which are, in part, directed at such problems
3. investigate modifications or alternatives that could address deficiencies
4. recommend options that are likely to yield the greatest net benefits.

Understanding the nature and extent of the problem requires an examination of executive pay setting practices and outcomes in theory and in practice. For example, can observed remuneration outcomes be explained by the characteristics of the market for executives? What are those characteristics? Which factors are more influential? How far short does observed behaviour fall from what may be realistically obtainable? What impact have remuneration outcomes had on company performance, economic efficiency and, ultimately, community living standards?

A basic challenge confronting such analysis is a dearth of consistent, long-running data. For one thing, there are no time series data of sufficient duration to be able to examine the change in remuneration outcomes across business cycles. The most detailed data the Commission has been able to access covers the six year period 2003-04 to 2008-09. Earlier data are not consistent. Moreover, data on total remuneration contains a mixture of base salary ('cash in hand') and estimates of incentive-based remuneration (shares and options) which may not be realised. The extent to which the accounting estimates are realised will vary with the business cycle itself. This not only makes it difficult to estimate trends in remuneration, but also what is driving those trends, and links to performance.

Given these difficulties, the Commission has made use of data from a variety of domestic sources, as well as research from the United States and other countries where appropriate, together with qualitative information, much of which has come from inquiry participants and experts in the field. It has sought to shine light on the issues in a variety of ways to test the soundness of different hypotheses. Ultimately, with all the uncertainty, considerable judgment is called for, particularly in relation to the magnitude of identified problems and the relative downside risks in intervening versus doing nothing.

In a highly interdependent market, there is also a risk that policy actions in one part of it will react adversely with actions elsewhere. It is important, therefore, to take a 'holistic' approach, in which the various elements of the system can be considered as a whole, to produce a package of actions that has coherence.

Pay quantum versus structure

The quantum of pay for the most senior of a company's executives is, in many cases, likely to form only a small component of total costs. This suggests that the impact of 'excess' quantum on companies, and therefore the productivity and growth prospects of the economy, may also be small. However, if the structure of executive pay distorted decision-making — particularly by CEOs — this could have wider ramifications and impose significant costs on companies and shareholders, and possibly more broadly. For example, pay structures that encourage undue focus on short-term results, could result in poor investment decisions over time and a less efficient use of resources in the wider economy. Furthermore, if changes in executive remuneration have flow-on effects to other company employees, it is likely to have more significant consequences for total production costs, although the extent to which this effect is present is an empirical matter.

Indeed, the terms of reference note concerns that remuneration structures in the financial sector promoted excessive risk-taking behaviour, and these arrangements have been identified by some groups as a major contributor to the global financial crisis (though, as identified in box 1.5, a range of other forces were at work). For this sector, excessive risk-taking leading to company failures could generate negative system-wide effects. Catastrophic failures in these areas can leave governments with little choice but to use taxpayers' money to bail out companies in difficulty. This means that the community bears (or shares in) costs normally borne by shareholders. This can, in turn, encourage a mismatch between the risk profiles of shareholders and that of the community. This matter is being addressed in several international and domestic fora, including by APRA.

There may be other impacts from both 'excessive' quantum and 'poor' pay structures that could spill over to the wider community. For example:

- if entrepreneurial effort is channelled into trying to maximise or camouflage remuneration, or other distorting behaviour, this could be at the expense of focusing on managing the business
- large disparities between executive pay and average earnings might demotivate a company's employees, adversely affecting productivity and making wage restraint more difficult to achieve during economic downturns
- if high levels of executive pay in some companies spread across other companies through demotivation and ratchet effects.

All of these considerations need to be evaluated and weighed against any efficiency impacts from intervention.

What role for community expectations and societal norms?

The preamble to the terms of reference refers to concerns in the wider community about excessive executive remuneration and the need for a regulatory framework that 'better aligns the interests of shareholders and the community with directors and executives'.

Box 1.5 **The global financial crisis: what role for executive remuneration?**

There is a common perception that the structure of remuneration in the financial sector (particularly in the United States) was a major contributor to the global financial crisis. However, market analysts have emphasised a number of other factors.

The UK Financial Services Authority observed in the Turner Review:

> There is a strong prima facie case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the global financial crisis.
>
> It is very difficult, however, to gauge precisely how important that contribution was. A reasonable judgment is that while inappropriate remuneration structures played a role, they were considerably less important than other factors … [namely] inadequate approaches to capital, accounting, and liquidity. (FSA 2009b, p. 80)

The International Monetary Fund state that the shadow banking system (investment banks, hedge funds, mortgage brokers, and the like) were lightly regulated by a number of different bodies, and generally not supervised prudentially, and identify this as a contributing factor to the crisis (IMF 2009). It also argues that investors relied too heavily on the advice of credit ratings agencies. Furthermore, too few central banks estimated the build up of systemic risk arising from increases in asset prices and leverage, relying on prudential regulation to control such a build up. The International Monetary Fund observes that the practice of rewarding employees based on the generation of annual profits had pro-cyclical effects that magnified the credit boom, and called for the delinking of bonuses from annual and short-term financial results.

David Gruen (2009), from the Australian Treasury, has proffered five ‘proximate causes’ of the global financial crisis: global imbalances, low interest rates, US mortgage regulation, housing policies, and flaws in the ‘originate to distribute’ model for mortgages in the United States. He then identifies three ‘wider causes’: undue complexity of financial instruments, remuneration incentives in the financial sector to take excessive risks, and higher leveraging within the financial system — noting that the last of these is ‘one of the most important’.

While shareholders as a group could once be easily differentiated from the wider community, share ownership has widened considerably since the 1980s and the two groups have become increasingly coextensive (chapter 2). But there are circumstances where their interests (and interests within shareholder, employee and community groups) can diverge. For example:

- shareholders want the companies they invest in to perform well and deliver good returns, which can be at the expense of other companies and their employees and shareholders
- local communities have an interest in seeing the companies located in their regions performing strongly to provide economic stability, but this can be at the expense of other local communities

- employees have an interest in their companies (and those where their superannuation is invested) doing well in order to deliver stable employment, which can be at the expense of other companies' employees
- the community at large enjoys the benefits of low priced goods and services delivered through a competitive marketplace, which includes the process of new companies starting-up, and other companies laying off workers to survive, or going bankrupt.

This process of competition and 'creative destruction' is integral to economic growth and means that, while community sentiment about inequality or fairness in relation to executive pay cannot be ignored by governments, neither should the national income consequences of intervention. Ultimately, the community's material wellbeing depends on the efficient operation of companies and markets over time. Organisational innovation and strategic decision-making by senior executives are central to this wealth-creating process. This is recognised in the preamble to the inquiry's terms of reference:

> It is also important to recognise that internationally competitive reward structures for company directors and executives continue to provide incentives for directors and executives to assume leadership responsibilities within corporations. (terms of reference, p. 1)

More generally, community 'norms' are often enshrined in legislation in a way that can override individuals' preferences (for example, requirements to wear seatbelts or product safety requirements for food). These norms reflect what the community at large thinks is 'right' or 'fair'. For example, while there is often a focus on the quantum of pay received by some executives, similar concerns are not evident for other, often more highly paid, individuals such as sports stars and entertainers. This suggests that the concerns derive more from the perception that executives can influence their own remuneration (in addition to other key differences in their roles and responsibilities). That is, high pay is accepted where people consider it to have been gained by fair means. It is apparent that many in the community who have raised concerns about executive pay do not think the status quo is delivering fair outcomes (box 1.6) and this underscores the importance of well-functioning pay setting arrangements. That said, there has been relatively little input to this inquiry from individual citizens or shareholders.

Laws that reflect social 'norms' typically in practice also serve to reduce recognised social harms. While it is not clear that concerns about executive pay have such attributes, if community concerns about executive pay led to a lack of confidence in corporate governance more generally, this could have negative implications for capital raising by companies and ultimately, the economic wellbeing of the community itself.

Box 1.6 **Public expressions of concern**

These bonuses/pay rises … are obviously immoral, wrong, indecent, crass, obscene … (Neil Buchanan, sub. 10, p. 1)

… huge payments to CEOs has finally reached crisis proportions. (Klaas Woldring, sub. 8, p. 2)

… the greed-crazed stampede by directors and senior executives to transfer company wealth into their own bank accounts. (Kenneth Park, sub. 21, p. 1)

Executive and CEO pay has increased out of all proportion to that justified by their productivity gains or increases in corporate performance. … [this] poorly serves the interests of shareholders, employees and the wider community. (Construction, Forestry, Mining and Energy Union of Australia, sub. 78, p. 11)

… ordinary workers are paid low wages, and even lose their jobs as part of cost cutting and efficiency measures that result in higher bonuses and salaries for the executives. (Elizabeth Oldfield, sub. 98, p. 1)

As far as it is ever possible to divine community feelings, it seems the community at large believes that multi-million-dollar salaries or packages are neither justified, warranted, or needed, and are simply 'wrong'. (Andrew Murray, sub. DD112, pp. 2–3)

The simple fact is corporate executives are paid in vast and increasing disproportion to their actual contribution to corporate and community prosperity … (Adrian Gattenhof, sub. DD120, p. 3)

A problem for government in responding to such concerns is that they may not be based on an adequate understanding of why problems have arisen and the consequences of attempting to fix them. Geoff Hogbin submitted that it is important to:

> … consider carefully the weight to be given to possible intangible benefits attributable to, say, satisfying 'community expectations' … because:
>
> - history has shown that the 'wider community's perceptions' can be inconsistent with the public interest generally (e.g. trade protection was, and is still, believed by many to be beneficial)
> - 'the wider community' may not take adequate account of unanticipated, perverse consequences of regulations … (sub. 99, pp. 2–3)

Questioning of the need to satisfy community expectations in this area is also reflected in RiskMetrics' evidence at public hearings (box 1.7).

While there may be some contention about the role of the community as a stakeholder on matters of executive remuneration, addressing any dysfunction within current governance and regulatory arrangements could deliver a broader public benefit. This holds even if the main impact of such dysfunction is internalised to shareholders and managers.

Box 1.7 **'Public outrage': whose interests are most relevant?**

Proxy adviser RiskMetrics' submission documents the numerous concerns it has about remuneration outcomes in Australia, particularly what it sees as questionable linkages between company performance and several highly remunerated executives:

> In some cases, based on recent experience in Australia and around the world, it appears that poorly designed incentive structures contributed to the demise of companies, illustrating that while executive remuneration may not be material as an expense it may create material risks. (sub. 58, p. 1)

However, RiskMetrics did not see community expectations as having a particularly strong claim as an input to policy solutions. An exchange at the public hearings illustrates this (trans., p. 378).

> **Commissioner Fitzgerald:** … In a sense, the public outrage is linked in part to the quantum and in part, particularly, the termination phase. I suppose we've asked a lot of participants this: should we be concerned about quantum …
>
> **Mr Paatsch (RiskMetrics):** No, you shouldn't be concerned about it, shareholders should be concerned about it, and if they don't like it, they should be able to toss the boards out and get new ones, new directors. That's it.

1.4 Conduct of the inquiry

The Commission has consulted extensively in the preparation of this report (appendix A). In addition to informal consultations and roundtables, 170 submissions have been received — 105 prior to the release of a Discussion Draft, and a further 65 in response to that draft. Many of the submissions were substantial.

An initial round of public hearings in Sydney, Melbourne and Brisbane provided an opportunity for groups and individuals to present evidence before the Commission. Submissions have been received from, and discussions held with:

- CEOs and senior executives
- company chairs and directors
- institutional investors, including funds managers and superannuation funds
- retail shareholders and their representative bodies
- proxy advisers
- remuneration and other corporate consultants
- regulators
- academic researchers.

The Commission released its Discussion Draft, *Executive Remuneration in Australia* (PC 2009) on 30 September 2009. The Commission proposed a package of reforms aimed at improving the accountability of boards, removing conflicts of interest, and enhancing shareholder engagement on remuneration. It sought further submissions on these proposals and held a further round of public hearings in Melbourne and Sydney from late October.

Overwhelmingly, participation has come from those with a *direct* interest in executive pay setting — the associations (for example, the Australian Institute of Company Directors and the Australian Shareholders' Association), companies (for example, BHP Billiton and Macquarie Group), governance consulting firms (for example, Regnan), remuneration consultants (for example, Mercer), proxy advisers (for example, RiskMetrics and CGI Glass Lewis), legal firms (for example, Freehills), unions representing company employees (for example, the Australian Council of Trade Unions) and academic researchers. As noted, there has been relatively little engagement by individual retail shareholders and members of the public.

1.5 Report structure

The structure of this report follows the terms of reference, which essentially ask the Commission to:

- establish the facts about executive remuneration
- assess the effectiveness of the framework of oversight, accountability, and transparency, including shareholder engagement and taxation arrangements
- make recommendations to promote better alignment between the interests of boards and executives with shareholders and the community more broadly.

There are four parts.

Part A outlines the Commission's analytical framework and discusses the rationale for, and evolution of, the public company structure.

Part B presents information on what has happened to the structure and quantum of executive remuneration over time and explores what has driven these outcomes.

Part C provides an analysis of the institutional environment, with assessments of the effectiveness of processes for determining executive pay (chapter 6), how pay is structured and linked to performance (chapter 7), and how boards engage with their shareholders through remuneration reporting (chapter 8) and through voting rights (chapter 9). The extent to which taxation influences remuneration quantum and/or structure is canvassed (chapter 10).

Because of the interactions that arise among these areas and the scope for policy changes in one area to impact on others, Part D integrates the analysis and findings in seeking to deliver a consistent set of policy proposals.

2 The role and evolution of the public company

Key points

- The public company model evolved to meet the challenge of accumulating the capital required to operate large-scale and complex production processes.
  - By separating investors' ownership from specialised managerial control, the public company structure facilitated access to large amounts of pooled capital.
  - This separation, however, gave rise to the potential for divergence of interests between owners and managers, known as the 'principal–agent problem'.
  - Executive remuneration is one area where the divergence between the interests of managers and owners has the potential to become especially acute.
- Various governance and regulatory arrangements have emerged to promote alignment of the interests of managers with those of investors/owners.
  - The primary alignment mechanism, which remains central today, is shareholders electing boards to oversee companies and represent their interests.
  - Regulatory frameworks emerged to underpin and reinforce the effective functioning of boards and these frameworks continue to evolve.
- Ultimately, a convergence of company, shareholder and community interests is achieved when companies maximise profits on shareholders' behalf, while taking into account any costs their activities might impose on the wider community.
- Public companies are an integral part of the Australian economy.
  - Australia's 2000 or so listed companies are responsible for more than $1 trillion in shareholder and investment wealth.
  - Just over 40 per cent of Australians participated in the sharemarket in 2008, apart from the more extensive share ownership via superannuation funds.

2.1 Evolution of the public company

Fundamental to analysing executive remuneration is an understanding of why public companies exist and the respective roles of management, boards, and shareholders. The joint stock company model has existed since the 17th century, but public companies as they are known today came to the fore after the industrial revolution. The 'mass shareholding' public company harnessed the incentives inherent in market economies in order to address a broad societal problem: how to accumulate the vast amounts of capital required to operate coordinated, large-scale and complex production processes. However, the resulting separation of ownership (the principals) from control (their agents) created other problems.

Separation of ownership and control

Modern companies evolved because the predominant pre-industrial revolution model of sole proprietors and/or partnerships providing the equity for, and running, businesses was ill-equipped to meet the challenges of more complex operations. Examples of such operations include obtaining economies of scale, specialisation in many areas (including management skills) and raising large amounts of capital.

Centralised and integrated company structures are more efficient because the transaction costs of conducting business, settling disputes, dealing with unforeseeable contingencies and enforcing contracts can be 'internalised' and thus reduced (box 2.1).

The Business Council of Australia (BCA) summarised these advantages thus:

> The listed company provides an effective mechanism to aggregate large amounts of capital for investment, to efficiently allocate and manage risk, accumulate expertise and knowledge and minimise the costs of doing business. (sub. 101, p. 7)

For a public company to amass equity capital effectively, two attributes are required. These are the capacity for investors to:

- delegate the management of day-to-day company affairs
- provide equity under conditions of limited liability — that is, to be able to confine their losses to their equity stake only.

The concept of limited liability

The modern business model was founded on the separation of ownership and control through pooled capital based on the principle of limited liability. As CGI Glass Lewis and Guerdon Associates submitted:

> The oil that lubricated the resulting and necessary separation of the ownership (by the scattered providers of the equity capital needed to fund) and conduct (by management and workers) of these businesses was the principle of limited liability. That limited the

liability of the owners to the amount of the capital they had agreed to contribute to the business …

Partly in return for this limited liability of their risk but also because they did not, as owners of the capital, manage or work in the business and, therefore, had neither the expertise nor the requisite intimate knowledge of the business to make competent business decisions, those owners had no authority or power under the constitution of the business to make such business decisions. (sub. 80, p. 11)

Limiting shareholders' financial liability — typically through reduced dividends if company profit is impacted or, in the case of insolvency, the value of capital invested — has been central to encouraging the accumulation of capital.

Box 2.1 **Benefits of the company structure**

The theory of the firm in the academic literature, which starts with Coase (1937), posits that centrally coordinated and vertically-integrated structures facilitate production at lower cost than decentralised markets where different links in the production chain are performed by atomistic units. Internalising factors of production (such as people and capital) within a firm can result in higher productivity than attempts to coordinate decentralised production of inputs. This is because the transaction costs from settling disputes, dealing with unforeseeable contingencies and enforcing contracts can be reduced — an efficiency gain that can underpin expanded activity or trade.

Other economists have explored the source of the productivity advantage of companies over other organisational forms. Williamson (1985) considered that companies better handle the need for investments in human and physical capital and reduce protracted opportunistic behaviour and disputes about the distribution of the profit residual. This, in turn, promotes more efficient investment and better use of assets.

Internalising production processes within a firm does not eliminate transaction costs. For example, there are the costs of monitoring and encouraging productive effort by employees. As these costs rise, the advantage of the firm as an organisation diminishes, setting efficient limits to company size. But transaction costs are not immutable — for example, technological developments in communications have probably facilitated larger efficient firm size (and probably reduced the cost of decentralised supply as well).

Limited liability and the 'social contract'

There is a view that the legal framework underlying the company structure invokes a reciprocal social obligation from companies.

For example, Hamilton and Tozer state:

> … corporations are granted rights as legal persons (citizens) under empowering legislation enacted by society's political representatives with the expectation of economic returns to investors, other businesses and society — provided the entities operate within the legal and moral boundaries applying to all 'citizens'. (2007, p. 2)

Consistent with this view, there is full liability on *companies* which, as legal entities, can be sued. Companies must also conform with numerous laws to protect public values, including environmental protection, occupational health and safety, workplace relations, consumer protection and human rights. Furthermore, the positional liability of company directors exposes these individuals to legal sanction — the Australian Institute of Company Directors noted that there are around '650 state laws making [directors] liable' (trans., p. 207).

Apart from legal obligations, many companies are electing to integrate broader social agenda (such as ethical standards and charitable work) into their charters. The St. James Ethics Centre has compiled a Corporate Responsibility Index for Australian companies since 2004, which assesses practices such as performance in social and environmental areas and the management of community and workplace issues (Corporate Responsibility Index 2009). Companies including ANZ, Boral, Foster's Group, and Suncorp-Metway have participated voluntarily.

Limited liability does, of course, protect shareholders from punitive damages or the extended reach of creditors. But, as shareholders are divorced from company decision-making, this should be uncontentious. If shareholders' assets beyond their equity stake (for example, their homes) were at risk, they would wish to take a more active interest in 'corporate behaviour'. However, this would compromise the capacity of companies to accumulate capital for productive purposes, which would leave society worse off.

In the absence of limited liability being 'conferred', a market solution could evolve through companies entering into a multiplicity of contractual relationships with individuals. Although this would facilitate access to equity, it would be unwieldy and involve substantially higher transaction costs than the shareholding model.

Reconciling the interests of managers and owners

With the separation of ownership of a business from its management, there is potential for managers (the agents) to act in ways that would not necessarily be in the best interests of investors (the principals). This is commonly referred to as the 'principal–agent problem'. For example, managers might have incentives to obtain perks, invest inappropriately, or exert lower levels of effort than they would if their actions were consistent with the interests of investors (and consequently deliver suboptimal performance). However, one area of the principal–agent relationship where the divergence between managers' and owners' interests has the potential to become particularly acute is remuneration. Executives will naturally take a keen interest in their remuneration and the most senior executives will potentially have scope to exert influence over decisions. This highlights the importance of establishing independent processes for remuneration-setting, as well as appropriate monitoring and incentive mechanisms.

Attempts to overcome the principal–agent problem have led to the evolution of various mechanisms to align interests. The primary means of achieving alignment is through investors electing representatives (directors on a board) to oversee the business — including hiring and firing the CEO and ratifying the appointment and removal of company executives. If dissatisfied with the performance of directors, investors can replace them. This fundamental approach to aligning interests dates back to the first joint stock companies and remains an essential feature of the modern business corporation.

Principal–agent issues feature in the literature in 'agency theory' and 'managerial power theory':

- Agency theory starts from a presumption that the separation of managerial control from ownership means that the interests of the former may not necessarily be perfectly aligned with those of the latter. Hence, incentives and controls may be required in order to induce managers to act in the best interests of the company and its shareholders, and thus achieve a greater alignment of interests.
- The managerial power theory also recognises the potential agency problem between owners and managers of a firm, but contends that managers can often exert undue influence over the board of directors.

Implicit in both approaches, which are not mutually exclusive, is the role of shareholders as the effective 'owners' of the company. Notwithstanding the 'nexus of contracts' view (box 2.2), it is generally accepted that in practice the shareholder body — en masse and over time — 'owns' the company in the sense that they have a claim over the profit residual.

For boards to effectively form this bridge between owners and the company, it is important that directors:

- have sufficient information to enable them to monitor executives' performance
- are able to devise incentive structures that can influence executives' behaviour

- are sufficiently at 'arm's length' from executives or have processes in place to overcome conflicts of interest
- provide sufficient information to enable owners to understand and scrutinise how executive remuneration aligns with their interests
- are subject to sanction through arrangements that enable owners to signal their satisfaction or otherwise with board performance, and ultimately to replace poorly performing directors.

Box 2.2 **What do shareholders 'own'?**

Some economists suggest that the notion of a company's shareholders as its 'owners' is either irrelevant or little more than a helpful metaphor. Fama argues:

> … ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this 'nexus of contracts' perspective, ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of security holders. (1980, p. 290)

Lipton and Savitt make a similar case:

> Shareholders do not 'own' corporations. They own securities — shares of stock — which entitle them to very limited electoral rights and the right to share in the financial returns produced by the corporation's business operations. Conceiving of public shareholders as 'owners' may in some instances be a helpful metaphor, but it is never an accurate description of their rights under corporate law. Shareholders possess none of the incidents of ownership of a corporation — neither the right of possession, nor the right of control, nor the right of exclusion — and thus have no more claim to intrinsic ownership and control of the corporation's assets than do other stakeholders. (2007, p. 754)

However, others take the contrary view, such as Langois:

> The shareholders 'own' the corporation because they have the final say: managers cannot change the nature or strategy of the corporation in a radical way without the consent of stockholders … (2002, p. 31)

Hart argues:

> A public corporation can still be usefully considered a collection of assets, with ownership providing control rights over these assets … Although owners (shareholders) typically retain some control rights, such as the right to replace the board of directors, in practice they delegate many others to management, at least on a day-to-day basis. (1989, p. 1773)

The fact that shareholders possess certain crucial control rights, such as the right to replace directors, while delegating management of the company to senior executives (giving rise to the classic principal–agent relationship), reinforces the notion that collectively, over time, shareholders 'own' the company.

The importance of these points is further recognised in corporate governance frameworks that, among other things, confer voting rights to shareholders over matters of board representation and remuneration reports — though Australia progressed earlier and further down this path than the United States (section 2.4).

Ultimately, a convergence of company, shareholder and also wider community interests is achieved through maximising the net present value of a company's future profit streams (subject to any external social costs being taken into account). Maximising the net present value of a company's future profit streams is in the interests of shareholders (who are a subset of the wider community), as it allows them to realise capital gains on the shares they hold and enjoy higher wealth. Hence, while the *Corporations Act 2001* (Cwlth) specifies that directors have a fiduciary duty to act in the best interests of the company, ultimately, this is consistent with shareholders' interests. However, reflecting the heterogeneity of shareholders, there are issues about the appropriate time path for achieving this. Some shareholders will prefer higher profits in the short term, whereas others will want profit maximisation to be pursued over longer time frames. An additional consideration, where institutional investors are present, is the extent to which their interests are aligned with those of the individuals on whose behalves they invest — particularly given Australia's compulsory superannuation arrangements.

While the notion of a relatively stable shareholder group may have been apposite many years ago, this is no longer the case. For example, according to Macquarie Group director and Origin Energy chair Kevin McCann:

> Macquarie Group has had 225 per cent of its share register turn over in the past 12 months and Origin had a 92 per cent turnover. (cited in Durkin 2009)

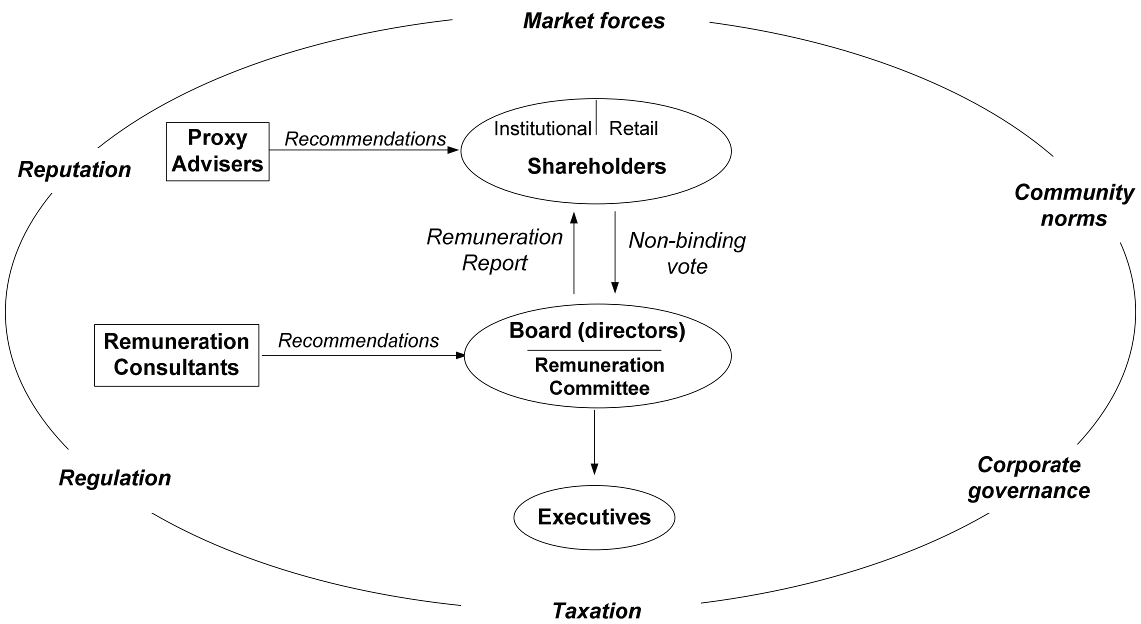
Rapid turnover of shareholdings obviously has implications for how companies engage with shareholders and underscores the importance of measures that can align company management with increasingly diffuse and changeable shareholder interests. All of this serves to reinforce the concept of shareholders as company owners only in a collective (average) sense and over time.

2.2 Aligning interests — the pivotal role of boards

As noted, the key formal mechanism for aligning ownership and control within a public company is the board of directors. Other influences also support this alignment (figure 2.1). For example, many executives will naturally take personal pride in doing a good job for the company and its shareholders. In addition, competition in the markets for a company's products imposes a discipline on managers by making poor performance apparent in the relative performance of the company. Lack of attention to costs, innovation, or marketing put a company at a disadvantage relative to rivals and reduce market share and profits. Moreover, poor performance by managers can damage their reputation and reduce their scope for promotion or alternative employment. It may also lead shareholders to sell their stock, causing the share price to fall and exposing the company to takeover or merger threats, thereby threatening the executive's position.

Nevertheless, sound oversight of management and the corporate governance framework that facilitates the relationship between boards and shareholders are central to achieving alignment in a systematic way. Ideally, boards act in the best interests of the company (as representatives of shareholders) and diligently and effectively monitor the actions of executives (as well as enacting mechanisms that achieve this objective). The board's ability to discharge these responsibilities is complicated by the fact that it cannot directly observe every action undertaken by an executive, or the level of effort they exert in their role on a day-to-day basis. Assessing the effectiveness of the various relationships within companies requires consideration of the roles of the key parties in this process: boards, chief executives and senior executives, and shareholders, and ultimately, those who advise them.

Figure 2.1 **Aligning interests: shareholders, board and management**



The role of boards

As noted, the Corporations Act specifies that directors have a fiduciary duty to act in the best interests of the company. The Act further stipulates some of the primary responsibilities of directors — that directors should not improperly use their position to gain an advantage for themselves or someone else, or improperly use their position to cause detriment to the company.

Boards set goals, authorise major decisions, finalise budgets and deal with legal, regulatory and compliance matters. Essentially, boards oversee and advise, but do not manage, companies. As noted by the Corporations and Markets Advisory Committee:

> The role of a board of directors is to direct a company on behalf of the shareholders. This includes setting the strategic direction and aims of the company, providing resources for their implementation, directing or overseeing the management of the company's business and compliance with its obligations. (CAMAC 2009, p. 12)

Some of the specific responsibilities of the board of directors, as noted by the Australian Securities Exchange (ASX) Corporate Governance Council, include:

- appointing and removing CEOs, and, where appropriate, ratifying the appointment and removal of senior executives
- reviewing, ratifying and monitoring systems of risk management and internal control, codes of conduct, and legal compliance
- providing input into, and final approval of, management's corporate strategy and performance objectives
- monitoring the performance of senior executives
- approving and monitoring the progress of major capital expenditure
- approving and monitoring financial and other reporting (2007a, p. 13).

While executive pay may not appear to loom large relative to many of the other board roles listed above, one of the most important roles is the selection of a CEO and oversight of his or her performance. This is directly related to remuneration — both its level and structure.

The role of the chief executive officer

Understanding why a CEO might be paid more than, or on a different basis to directors, other executives, or indeed, public office holders (box 2.3), requires consideration of what CEOs do and how much influence they can have on a company's performance and shareholder returns.

As the leader of the management team, the CEO has crucial responsibilities that require a range of high-level skills. As noted by Mercer:

> … as leader, the CEO directly influences business decisions, resource allocation and operational practices that determine financial outcomes for the firm … [and is] responsible for maintaining the confidence of shareholders and the investment community in the strategic direction and operational capacity of the company while also serving the internal role of maintaining effective relationships between the board and management. (sub. 41, p. 5)

Box 2.3 **Are heads of companies 'worth' more than heads of governments?**

Jonah Versteegan contended that CEOs should be on fixed pay because this is good enough for 'the Governor General, the Prime Minister, the Chief Justice and all politicians and members of the Judiciary' (sub. 12, p. 1).

The Remuneration Tribunal, the independent statutory body which advises on remuneration for Commonwealth officials, made observations of a similar nature:

> … based on a consideration of similarities in roles and responsibilities at the most senior levels of each [private and public] sector, there is an argument that the remuneration of public offices should be accorded some weight in setting appropriate remuneration for senior private sector positions. (sub. 102, p. 1)

The Tribunal acknowledged:

> … the position of [Departmental] Secretary (does) not have comparable accountability to that of a Chief Executive ... where those executives have traditionally been accountable for creating shareholder value with a primary focus on developing and implementing strategies to achieve growth in revenue, assets and profitability, with an increasing international footprint ... (sub. 102, p. 5)

Large public companies are complex, have multiple activities and can span continents. CEOs of major companies have considerable discretion in decision-making and operate in an environment where small differences in their capabilities can have large ramifications for companies and shareholders. Therefore, they can be crucial in determining the success or otherwise of a company. The implication is that, for major companies at least, the CEO position is as much about the calibre and qualities of the individual as the 'job task list'.

The BCA attested to the CEO's influence:

> The defining characteristic of the CEO position is that the scope and size of the role and its accountabilities require significant personal latitude, judgment and responsibility. The complex mix of skills required to succeed as a public company CEO are often poorly understood in the public domain despite the presence of ample evidence pointing to the very public and often stark divergence in the performance of corporations during the tenure of different CEOs. (sub. 101, p. 8)

Given the dominance of the CEO in shaping the performance of a company over time, it is clearly important that CEOs are given appropriate incentives to act in the company's best interests. As noted previously, there are some inherent forces for alignment. Nevertheless, there is unlikely to be *perfect* alignment between CEO and company interests, and any differences could be significant in terms of outcomes — explaining the increasing movement towards providing more incentive-based pay (see chapters 3, 4 and 7).

The role of shareholders

According to an ASX study, a substantial proportion of Australians now participate in the sharemarket (table 2.1). The ASX reported that:

> … 6.7 million people, or 41 per cent of the adult Australian population, own shares. This is down from 46 per cent two years previously and, undoubtedly, reflects investors' responses to current volatile market conditions after long periods of strong market performance. (2009c, p. 2)

The ASX also noted that:

> … participation was either direct (via shares or other listed investments) or indirect (via unlisted managed funds). The level of direct participation was 36 per cent, or approximately six million people. (2009c, p. 3)

The ASX study covers direct investment (predominantly shares but also including other investments such as real estate investment trusts, options, and infrastructure funds) and indirect investment through unlisted managed funds. But it excludes the additional and widespread arm's length involvement of the workforce through compulsory superannuation contributions.

Table 2.1 **Australians 'actively' investing in shares**

	Units	*1997*	*2000*	*2002*	*2004*	*2006*	*2008*
Direct only[a]	'000	1 645	3 133	2 268	3 358	3 471	4 096
Direct and indirect	'000	1 177	2 563	2 774	3 066	2 524	1 802
Indirect only	'000	1 861	1 709	1 898	1 606	1 262	820
Total	'000	4 703	7 405	7 300	8 030	7 257	6 718
Population 18+	m					15.8	16.4

[a] Direct investment relates to shares or other listed investments and, from 2008, self-managed superannuation funds. Indirect investment relates to unlisted managed funds. Excludes investments held in superannuation funds (other than self-managed funds).

Source: ASX (2009c, p. 7).

Earlier ASX studies indicate that in the late 1980s, fewer than 10 per cent of Australians were share owners. Part of the expansion, at least since the early 1990s, is attributable to a series of major privatisations and demutualisations. More recently, the number of Australians investing in shares has grown by two million since 1997 (table 2.1), with shareholders now representing nearly one-half of the Australian community over 18 years of age.

The primary motivation for individuals to own shares was analysed by the ASX in a survey conducted in 2008. The responses were categorised as follows:

- to make money — 33 per cent
- long-term capital gain — 27 per cent
- saving for retirement — 15 per cent
- for diversification — 12 per cent
- gifted, or from work — 8 per cent
- liquidity — 5 per cent.

Only five per cent of the investors surveyed considered themselves to be 'very knowledgeable' about shares. Forty-six per cent of shareowners considered themselves to be either not very, or not at all, knowledgeable (ASX 2009c, p. 27). This would suggest that most individual Australian shareholders have considerable confidence in the institutions of the sharemarket, with 78 per cent of respondents indicating a belief that the Australian sharemarket is 'well regulated'.

The growing importance of institutional investors

It is important to note the distinction between 'retail' and 'institutional' investors. The former consist of individuals who buy and sell securities in the course of maintaining personal investment portfolios. Institutional investors, however, are specialised financial institutions that manage the collective savings of a number of small investors, with the aim of achieving particular risk, return and maturity objectives.

As noted by Davis and Steil (2001), institutional investors possess certain characteristics that are advantageous when trading securities. For example, they can provide a mechanism for risk pooling for small investors (by holding a large spread of domestic and foreign investments), thus allowing a better tradeoff between risk and return than individual investors alone might be able to achieve. Institutional investors also have a superior ability to acquire and process information than retail investors, and by trading large quantities of assets such as shares and bonds, may be able to attain economies of scale, which can result in lower average costs for investors. Perhaps most importantly, the growing significance of institutional investors (across the world) should lead to deeper and better functioning financial markets, contributing to a more efficient allocation of household savings (CGFS 2007).

Institutional investors have a fiduciary duty to act in the best interests of their member investors. However, fund managers may not have incentives that completely align their interests with those of their members, giving rise to the need for monitoring and fees contingent on performance. One retail investor observed:

> The problem is one of pure agency. Large superannuation and pension funds are simply not put under pressure by their members to act in their interests (many of whom are unaware of who they are ultimately investing in) and accordingly, fail to pursue members interests … (David Beattie, sub. DD155, p. 1)

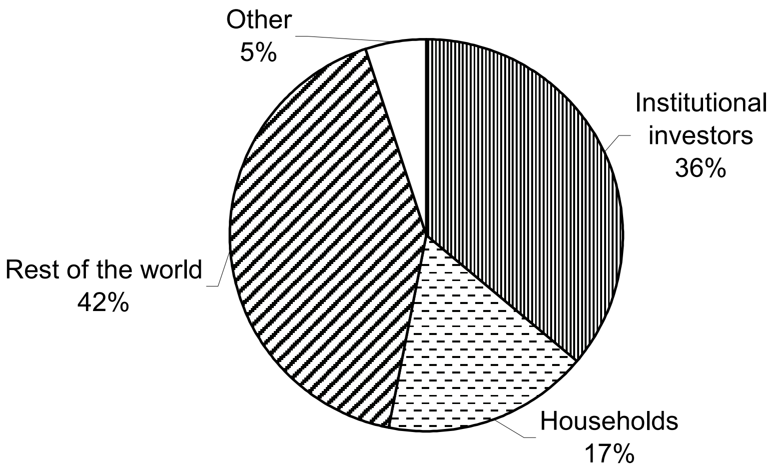
Examples of organisations classified as institutional investors include superannuation (pension) funds, life insurance companies, and investment companies, such as mutual funds. Superannuation funds collect and invest contributions made by workers and employers to provide post-retirement cash disbursements to workers. Life insurance companies collect premiums from selling life insurance contracts and annuities, which may be invested in order to meet the long-term contractual liabilities they incur. Investment companies typically pool assets for investment purposes, and often differ from other institutional investors in that liabilities, such as retirement income needs, are usually not a direct operational concern after investments are made (CGFS 2007, p. 4).

The combination of Australia's compulsory superannuation system and the use of equities as an investment tool by superannuation funds (see below) means that the number of Australians who have an interest in the performance of the sharemarket comprises a significant proportion of the population. The ABS (2009e) estimates that, in 2007, approximately 11.6 million Australians had superannuation coverage, of the 16.4 million persons in the population aged 15 and over. Furthermore, this significance has increased over time, given the growth in the share of the population with superannuation coverage. For example, the ABS estimates that, in 1974, 28 per cent of persons aged 15 and over had superannuation coverage, rising to 66 per cent by 1993, and to 71 per cent by 2007 (ABS 2009d).

Australian institutional investors hold a significant proportion of total listed shares and other equity in Australia (figure 2.2), accounting for over a third of the total on issue in June 2009 (around $390 billion worth). By contrast, households held approximately $189 billion of listed shares and other equity, or around 17 per cent of the total value. Foreign investors purchasing equity listed on the ASX also hold substantial amounts — $452 billion worth, equivalent to roughly 42 per cent of the total value issued (ABS 2009b). This amount is likely to reflect, in large part, the holdings of Australian equity by overseas institutional investors. Foreign retail investors are unlikely to rely heavily on a strategy of purchasing securities issued in several different countries to diversify their portfolios, due to the informational and transaction costs they would face in doing so.

The data cited above relate only to holdings of equity listed on the ASX. Institutional investors (including superannuation funds) diversify their portfolios through purchases of equity in companies listed on foreign securities exchange markets, so that the total value of all securities held by institutional investors is greater than the value of Australian-issued securities alone.

Figure 2.2 **Ownership of listed shares and other equity in Australia**[a, b]
Total proportion, June 2009



[a] 'Institutional investors' includes: superannuation funds, life insurance corporations and financial intermediaries (not elsewhere classified). [b] 'Other' includes private non-financial corporations, banks, other insurance corporations, national general government, and state and local general government.

Source: ABS (2009b).

Data also indicate that equity comprises a significant share of the total assets held by Australian superannuation funds. In the June quarter 2009, for example, superannuation funds held around 30 per cent of their total assets in the form of Australian trading corporation and financial sector shares (this proportion is higher if investments held in the form of units in trusts are included, which share some of the characteristics of equity but are not strictly classified as equity). Furthermore, superannuation funds held approximately 16 per cent of their assets overseas (ABS 2009f), part of which is in the form of equity listed on foreign securities exchange markets.

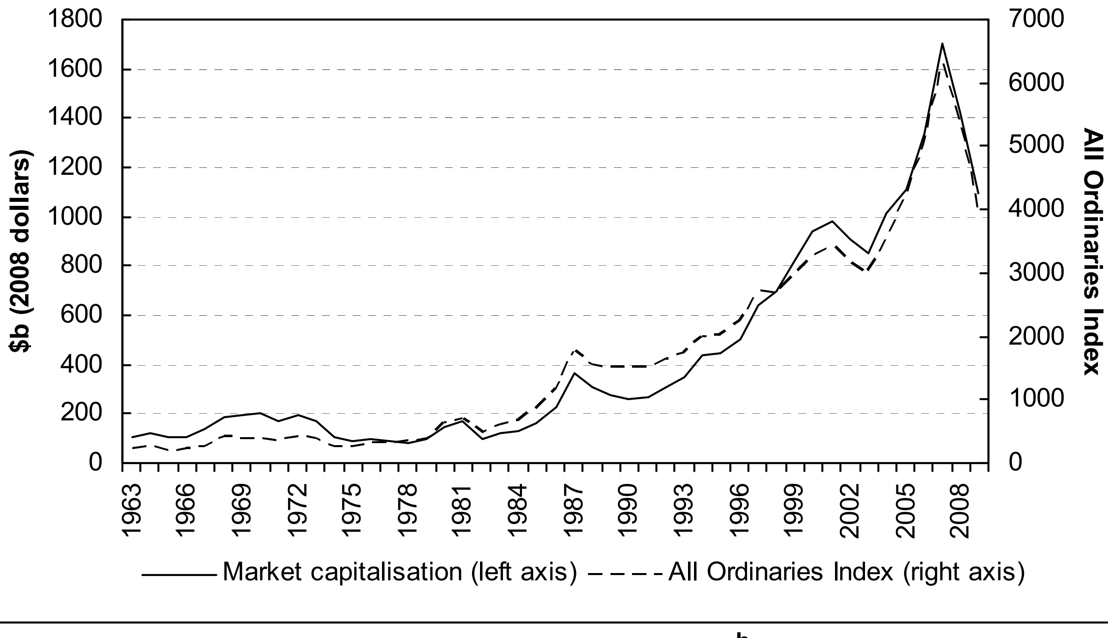
The high proportion of the population with funds invested in superannuation, the significant quantity of funds owned by institutional investors, and the significant weight given to shares in the portfolios of such investors, all demonstrate the importance that the performance of listed companies has for the wealth of individuals. Even if a person does not individually own shares, their superannuation fund will likely hold some shares in an investment portfolio managed on their behalf, and most individuals are therefore — either directly or indirectly — owners of shares.

2.3 The contribution of Australia's public companies

The public company has proven an effective organisational form and an important means of producing goods and services and providing employment, generating significant wealth in Australia.

The market capitalisation of Australia's listed companies was at low levels in the 1960s and 1970s, but rose sharply from the 1980s into the 2000s, reaching a peak of around $1.7 trillion (in real terms) by the end of June 2007, before the global financial crisis took its toll (figure 2.3). The All Ordinaries Index follows a similar path to market capitalisation over time.

Figure 2.3 **Historical stock market data**
Market capitalisation[a] and the All Ordinaries Index, 1963 to 2009[b]



[a] Expressed in 2008 dollars, deflated by the GDP implicit price deflator. [b] End of June values.

Sources: ABS (*GDP Implicit Price* Deflator, Cat. no. 5206.0); ASX (2009b); Economagic (nd); RBA (1997); Yahoo! Finance (2009a).

Despite the effect of the global financial crisis, Australia's nearly 2000 listed companies were responsible for over $1 trillion in shareholder and investment wealth (as measured by market capitalisation) at the end of June 2009. This is a significant increase on the corresponding value at the end of June 1963, which was approximately $100 billion (in real terms). More recently, the number of entities listed on the ASX has risen by approximately 47 per cent since 2002 (table 2.2).

Table 2.2 **ASX listed companies[a], 2002–09**

	2002	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Number of listed companies	1 351	1 360	1 459	1 570	1 758	1 892	2 008	1 980

[a] Year ended 30 June.

Source: ASX (2009e).

There has been relatively little research into the contribution of companies to the Australian economy. One study published by the Department of Foreign Affairs and Trade in 2002 examined the contribution made by the top 100 domestic and foreign businesses in Australia (box 2.4) (drawn from the Business Review Weekly's listing of the largest enterprises based on worldwide revenue, and using ABS data). It reported that, in 1999-2000, these companies accounted for around 20 per cent of the nation's total revenue, 11 per cent of the nation's employment, 35 per cent of Australia's merchandise exports, 48 per cent of Australia's export of non-travel services and 90 per cent of the total stock of Australian foreign direct investment abroad.

A BCA study of 71 of its members (all large corporations), indicated a contribution of similarly large magnitude (BCA 2004a, 2004b). The BCA reported that in 2001-02 its member companies:

- returned $18.4 billion in dividends to shareholders (of those that were publicly listed in Australia)
- employed more than 900 000 Australians
- exported goods/services of $47 billion
- paid a third of all corporate taxes, collected a third of all Government GST receipts and paid a further $13 billion in other taxes, royalties and duties
- expended $16 billion in new business investment.

Although the Department of Foreign Affairs and Trade study and BCA survey encompass only the upper echelon of Australia's nearly 2000 listed companies, it is apparent that the fortunes of Australian companies and overall community wellbeing are inextricably linked. Further insights come from ABS data. In total, across a wide range of industries, large businesses (defined as those that employ 200 or more persons) accounted for substantial shares of employment (27 per cent), wages and salaries (39 per cent), and industry value added (39 per cent) in 2007-08 (ABS 2009a), though they obviously include a wider range of businesses than publicly listed companies.

Box 2.4 **Australia's top 100 enterprises — findings for 1999-2000**

The top 100

The top 100 domestic and foreign businesses accounted for:

- 20 per cent of the nation's total business revenue and 11 per cent of the total workforce
- 70 per cent of the total capitalisation of the ASX
- 35 per cent of Australia's merchandise exports and 48 per cent of Australia's export of non-travel services
- 90 per cent of the total stock of Australian foreign direct investment abroad.

As a group, the top 100 derived almost a quarter of their revenues offshore.

The 26 companies in the top 100 that have a top 100 asset *and* employment ranking

These 26 companies accounted for:

- nearly 60 per cent of domestically-generated and worldwide revenues of the top 100
- around 60 per cent of the capitalisation of the ASX
- over 80 per cent of the total stock of Australian foreign direct investment abroad
- nearly 90 per cent of the revenue derived from offshore operations by all the top 100.

On average, these 26 companies derived 35 per cent of their revenues offshore.

The 31 majority foreign-owned companies in the top 100

These 31 companies accounted for:

- around 37 per cent of the revenues of all foreign-controlled companies and around 22 per cent of the revenues of the top 100
- 6 per cent of the nation's revenue
- approximately 20 per cent of Australia's merchandise exports
- more than a quarter of the stock of foreign direct investment in Australia.

Source: DFAT (2002).

2.4 The evolution of the regulatory framework

As noted, Australia's system of corporate governance is based on a combination of 'black letter' and 'soft' law, as well as a number of non-regulatory guidelines. This regulatory and corporate governance framework sets the parameters within which company boards determine director and executive remuneration (discussed in more detail in chapter 5).

It is important that regulatory and governance arrangements address the two potential sources of agency problems — between managers and shareholders on the one hand, and between managers and boards on the other. Ensuring that these problems are addressed has involved regulatory initiatives. Modifications to corporate governance arrangements have arisen from time to time to improve the alignment of interests.

The evolution of Australia's corporate governance framework can be gleaned from the following milestones, a number of which have acted to increase the 'say' of shareholders:

- 1998: Detailed pay disclosure required for individual company executives (box 2.5).
- 2003: The ASX Corporate Governance Council 'Principles and Recommendations' released — with compliance on an 'if not, why not' basis.
- 2004: The non-binding shareholder vote on companies' remuneration reports was introduced.
- 2005: Amendment to the ASX listing rule to remove the need for shareholder approval for granting equity to directors that is purchased on market.
- 2009: Legislation introduced to change the threshold and scope for shareholder approval of termination benefits.

Part C has a more detailed treatment of Australia's regulatory and corporate governance framework.

Remuneration for directors and executives in the United States is generally an order of magnitude higher than the levels that prevail in Australia for companies of comparable size (see chapter 3). RiskMetrics observed that:

> … Freeport-McMoran two years ago, its executive chairman was being paid $US70 million and the person running BHP, which was six times larger, was getting $10 million, and half of that was actually an accounting value that was very hard to get. (trans., p. 377)

One posited reason for this difference is that corporate governance arrangements vary markedly between the two countries. For example, a non-binding vote on companies' remuneration reports has become an integral element of Australian arrangements, but generally does not apply in the United States. US corporate governance arrangements are also built on a more 'director-centric' basis (Lipton and Savitt 2007), reflecting the influence of the corporate law in the state of Delaware, where more than 50 per cent of all publicly traded companies have their legal home (Delaware Division of Corporations 2009).

Box 2.5 **Changes to the requirements to disclose remuneration**

Requirements for disclosure of director and executive remuneration in Australia have widened significantly since the 1980s:

- Prior to October 1986: firms were required to disclose the collective remuneration (in bands) paid to all executives earning over $100 000.
- 1986–1987: firms had to identify all directors and their remuneration and the five highest paid executives and their total remuneration. As noted by Hill (1996) these regulations were objected to by a number of business organisations, which may account in part for their 'brief legislative life'.
- 1987 – 30 June 1998: listed companies were required to report the total annual 'emoluments' (cash and non-cash remuneration) received by executives earning over $100 000 (in $10 000 bands), but did not have to identify the executives. Directors' remuneration had to be disclosed in $10 000 bands.
- 1 July 1998 – 30 June 2004: listed companies were required to disclose in the annual report the remuneration packages (including base salary, short- and long-term incentives and other payments and allowances) of all directors and the five most highly paid executives.
- Since 2004-05: an expanded information set covering a wider range of directors and executives has been required in a remuneration report (which forms part of the annual directors' report) and on which shareholders have a non-binding vote.
- 30 June 2003: the Australian Securities and Investments Commission issued guidelines requiring companies to place a reliable valuation on options granted as part of remuneration packages. The guidelines allowed companies to choose from a number of valuation methods (Black–Scholes, lattice (binomial) or Monte Carlo simulations).

Sources: Hill (1996); Merhebi et al. (2006).

An outspoken academic critic of executive remuneration in the United States, Lucian Bebchuk, in testimony before the US House of Representatives Committee of Financial Services, proposed regulations that would move the United States towards an Australian-style system of corporate governance:

> … shareholders' rights in US public firms are significantly weaker relative to the UK and other common law countries. In addition to introducing advisory say-on-pay votes, it is important to strengthen shareholder rights in a number of other ways. In particular, it would be desirable to dismantle existing impediments to shareholders' ability to replace directors and shape companies' corporate governance arrangements. (Bebchuk 2009, pp. 6–7)

One area where Australia, the United States and United Kingdom are similar is in their unitary structure for board governance, whereby executives and non-executive directors sit on one board. Some European countries have instituted a dual board system with non-executive directors on a 'supervisory' board, and executives on a separate 'management' board. (The operation of boards in Australia is discussed in chapter 5.)

Australia's corporate governance framework is highly regarded internationally. A survey by GovernanceMetrics International in 2008 ranked Australia fourth in the world out of 38 countries (GovernanceMetrics International 2008). That said, the evidence is not conclusive about the impact of particular elements of corporate governance on company performance. For example, while many highlight that US board structures appear to lack the degree of independence that typifies Australian boards, the comparative track record of US companies for wealth generation stands up well. The literature suggests that corporate governance can be very context-specific. Indeed, there are many examples to suggest that companies with high levels of managerial ownership operate at least as effectively as those with more diverse and independent board structures. These issues are also explored in this report.

Australia's regulatory and corporate governance framework with its mix of 'black letter' law bolstered by 'if not, why not' guidelines, has evolved over time and reflects various 'rules of thumb' that attempt to balance prescription with flexibility. As all of these changes involved a degree of judgment, it would be surprising if current arrangements could not be improved.

PART B

REMUNERATION TRENDS AND DRIVERS

3 Trends in remuneration

Key points

- The available data suggest that the average remuneration of executives in ASX100 companies grew in real terms at an average annual rate of around 6–7 per cent between 1993 and 2009. This equates to an increase of 170–210 per cent over the period, or an increase from 17 times average earnings in 1993 to 42 times in 2009.
  - Executive pay grew significantly more strongly in the 1990s, with slower (but still positive) growth from 2000–07.
  - Average executive remuneration peaked in 2006-07, before falling significantly in the next two years, returning in 2008-09 to levels recorded in 2004-05.
- High levels of executive remuneration are most common at the largest companies. For example, in 2008-09, the average total remuneration of CEOs at the largest 20 companies (by market capitalisation) was approximately 50 per cent higher than for the next 20 largest companies, with remuneration levels declining progressively for smaller companies.
- After 2004, most of the growth of executive remuneration was accounted for by growth in the estimated value of incentive-based pay. This trend is particularly marked at the largest companies.
  - The extent to which there has been substitution for fixed remuneration is unclear, though base pay has declined in real terms since 2003-04.
- CEO remuneration in Australia is much lower than in the United States, which is the outlier internationally, and appears on average to be similar to smaller European countries.
- At the aggregate level, executive remuneration growth rates since 1988 are broadly consistent with the rate of growth of the ASX200 accumulation index.
- Directors' remuneration is less complicated than executive remuneration, generally taking the form of cash salaries.
  - Their remuneration grew at approximately 8 per cent per year over the period 1993–2008.

3.1 Introduction

This chapter investigates trends in director and executive remuneration. It looks at the quantum and structure of remuneration packages; how remuneration varies across companies of different sizes and industry sectors; the relationship between remuneration and corporate performance; and how the remuneration of Australian executives compares to that of their counterparts overseas.

Participants have made a range of statements about trends in executive remuneration in Australia (box 3.1). While there is some contention, most of the statements point to executive remuneration growing much faster than average weekly earnings and inflation. This chapter looks beyond the 'headline' numbers.

From the outset it must be acknowledged that there is no single, consistent, time series data before 1993. Data derive primarily from reporting obligations on companies under the Corporations Act, but these have varied in detail and changed several times over the past 20 years. Moreover, the increased use of equity-based remuneration (including grants of shares and options) complicates reported figures. Given these limitations, the Commission has had to present most of its conclusions using a range of estimates, and focus on more recent periods.

Nevertheless, it has been possible to reach some significant conclusions about trends in executive remuneration and to point to some of the factors that might have contributed to those trends. The factors that have driven the growth in remuneration are discussed in greater detail in chapter 4.

Box 3.1 **Statements about trends in executive remuneration**

A number of participants commented on trends in executive remuneration. For example, the Australian Council of Super Investors observed:

> Over the period from 2001 to 2007, median fixed remuneration [of CEOs in the top 100 companies] increased by 96.4 per cent in total, or 11.9 per cent per annum compound, even allowing for the slight decrease in median CEO fixed pay in 2007. Over the same period, average adult weekly ordinary time earnings increased by 32.3 per cent, while the consumer price index increased by 17.7 per cent. (sub. 71, attachment 1, p. 8)

David Peetz noted:

> The growth in CEO pay, of something around 470 per cent over the period 1971–2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period. (sub. 50, p. 3)

The Australian Council of Trade Unions stated:

> Between 1990 and 2005, the average cash remuneration of CEOs in top 50 listed Australian companies rose by 564 per cent, from $514 000 to $3.4 million, or 10.7 per cent per annum adjusted by inflation. During the same period, average full-time earnings only rose 85 per cent, or 1.4 per cent per annum adjusted for inflation. The result is that top CEO pay has ballooned from a multiple of 18 times average full-time earnings to a multiple of 63. (sub. 82, p. 1)

CRA Plan Managers contested the suggestion that executive remuneration has grown strongly. Referring to the period 1999 to 2008, it stated:

> … CEO and Chairman's remuneration (with [long-term incentives] excluded) at the 75th percentile has not kept pace with the rate of growth in the ASX/S&P 300 Accumulation Index over the period or AFL player payments. CEO [total fixed remuneration] at the median has not kept pace with [the consumer price index], average weekly earnings, AFL player earnings, public servant remuneration increases or the ASX/S&P 300 Accumulation Index over the period. (sub. 103, p. 13)

3.2 Data difficulties and the Commission's approach

For over 20 years, Australian listed companies have been required to disclose the remuneration of their directors and some executives. In addition, for many years some companies have voluntarily disclosed details of executive remuneration to certain consulting firms. The Commission has accordingly drawn on publicly-available data as well as some data supplied by remuneration consultants. (Appendix B describes the data sources in detail.)

The publicly-available data and that from remuneration consultants apply to companies in the ASX300[1]. However, there are close to 2000 entities listed on the ASX, most of them very much smaller than the top 300. To gain an understanding of remuneration practices at smaller companies, the Commission took a sample of companies from outside the ASX300 (see appendix B). While the sample is too small to be conclusive, evidence drawn from it can usefully illustrate some differences.

The Commission has not been able to create a database of remuneration practices over a broader sample of companies or over a longer period, as this would have exceeded the time and resources available for uncertain benefits. Furthermore, the requirements for companies to disclose the estimated value of long-term incentives changed in 2004. Information from remuneration reports prior to that date is not directly comparable with data since.

The Commission has necessarily focused on 2003-04 to 2008-09

The most detailed and consistent data (the Financial Review Executive Salary Database) cover the ASX300 over the period 2003-04 to 2008-09. The data set comprises, for each executive named in the remuneration report, the value of all sources of remuneration, including:

- base salary and other entitlements (such as superannuation and vehicle expenses)
- retirement benefits
- short-term incentive payments received
- the estimated value of long-term incentives granted over the year.

These data have been used to investigate trends in the various components of executive remuneration packages, how remuneration varies across companies of different sizes and across industries, and the relationship between executive remuneration and corporate performance.

Other data sources were drawn on where appropriate. Also, where possible, more than one data source was used to confirm findings. Interpretation of the data should take into account the difficulties that arise in comparing data sets over time (box 3.2), and the valuation of long-term and equity-based remuneration (see appendix E).

[1] The ASX300 consists of securities listed on the Australian Securities Exchange (ASX). It ‘includes up to 300 of Australia’s largest securities by float-adjusted market capitalisation’ (Standard and Poor’s 2007, p. 5). Other indexes referred to in this chapter include the ASX50 (the 50 largest stocks) and the ASX100 (the 100 largest stocks).

Box 3.2 **Comparing data on executive remuneration over time**

Difficulties arise when comparing disparate sources of data on executive remuneration over time. Failing to acknowledge or account for these is likely to lead to incorrect conclusions about the trends in remuneration. The most significant problems are listed below.

- Remuneration disclosure requirements have changed significantly over time.
- The data are derived from different samples of companies. The data sources referred to by the Commission include surveys of the top 50 companies, the top 100, top 300 and top 350, as well as surveys of the clients of remuneration consultants.
- The sources report data on the remuneration of executives at different levels, including CEOs, the second highest-paid executives, the top three executives and all non-CEO executives.
- Some data sources report median remuneration, others report average remuneration. There is generally a significant difference between the median and the average remuneration of any given sample of executives, because a small number of highly-paid executives tend to skew the distribution. For this reason, average remuneration tends to be higher and more volatile over time.
- Publicly-available data sources prior to 2003-04 report only average or median remuneration of groups of executives, without reference to the size of the companies they work for or the sectors in which they are employed. Remuneration is not broken down into different components (such as base pay, and short- and long-term incentives).

It is difficult to estimate the value of equity-based incentives

A significant proportion of executive remuneration is granted as long-term and equity-based incentive payments, including shares, options and 'performance rights'. Companies are required to estimate the value of long-term incentives when they are granted, and publish this figure in the remuneration report. Estimating the value of equity-based remuneration involves forecasting the value of financial derivatives over an extended period (typically two to three years) which will be subject to the fluctuations of financial markets.

The estimated value that companies place on shares or options for accounting purposes at the date they are granted (the 'accounting value') can differ significantly from the realised value when they vest. The value that executives place on equity-based payments will be different again. There are a range of opinions on whether reported estimates of the value of long-term incentives tend to under or overestimate the realised value (box 3.3).

The Commission's analysis is based on the reported 'accounting value' of long-term incentives.[2] This is the only practical option, for several reasons, including:

- companies do not report the realised value of long-term incentives that were granted in previous years, so it is not possible to go back and 'correct' the reported data
- remuneration reports do not contain sufficient information to estimate the value of long-term incentives using a consistent methodology
- even if such information were available, there is no 'right' way to value equity-based incentives (appendix E).

Given this, the data should be interpreted with care. The data presented on the value of executive remuneration in a given year could over- or understate the final value of the remuneration received by the executive. This is significant because estimates presented in section 3.2 show that average base remuneration (the fixed component of remuneration that is paid as a cash salary) in 2008-09 was lower in real terms than it was in 2003-04. Most of the growth in executive remuneration over the period 2003-04 to 2007-08 was accounted for by growth in the estimated value of long-term incentives, and the reduction in the value of long-term incentives made a significant contribution to the decline in total executive remuneration since 2006-07. Therefore, the estimated real growth rate of executive remuneration is highly sensitive to the assumptions that underpin estimates of the value of the incentive component.

2 Where data from the Hay Group are reported, the value of equity-based incentives has been estimated by the Hay Group on a consistent basis for all companies in the sample.

Box 3.3 **Do companies under- or over-estimate the value of long-term incentives?**

Some participants have stated that the estimated accounting value of equity-based incentive payments systematically under-estimates the realised value. For example, RiskMetrics studied 24 ASX100 companies in 2005-06. The study examined 70 tranches of options awarded to CEOs. Of these, two-thirds were exercised and one-third lapsed. Of those that were exercised, the estimated 'fair value' was, on average, only 26 per cent of the realised value (sub. 58, attachment 3).

A later study by RiskMetrics (commissioned by the Australian Council of Super Investors) stated that changes to the way performance hurdles are applied to long-term incentives mean that the reported values of long-term incentives might overstate the value received by the executive. It stated that:

> … the increased use of relative [total shareholder return] hurdles over the past six years may mean that fewer CEOs are achieving the hurdles required for [long-term incentives] to vest. Where the [long-term incentive] does not vest, the actual value received by a CEO from the [long-term incentive] will be lower than the reported value. (sub. 71, attachment 1, p. 22)

Others agreed that performance hurdles might mean that the estimated accounting value overstates the realised value. For example, Regnan stated:

> Many long-term incentive figures are overstated in company disclosures due to accounting standards, which require amortisation of some long-term incentive grants prior to performance testing. If performance hurdles are not met, an executive may not even realise these rewards which have already been accounted for. (sub. 72, p. 4)

Stern Stewart and Co. suggested that regardless of the estimated value, many executives place little value on equity-based remuneration that has not vested. The submission paraphrased a conversation with a typical executive:

> … I put them in the bottom drawer and forget about them until they vest. There's just too many factors outside my control that mean they may be worth nothing. (sub. 53, p. 4)

Given the range of assumptions that underpin the estimates of the value of equity-based incentives, it is almost certain that the realised value will differ from the estimated value. It is not clear whether the estimated values reported in remuneration reports will tend to over- or understate the realised value. Nor is it clear how the estimated value relates to the value perceived by the executive.

However, it is probable that the unanticipated boom in equity markets in the 1990s led to the realised values of equity-based remuneration being higher than was estimated when the equity was granted. Similarly, given the decline in the value of equity markets since 2007, it is likely that many equity-based incentives that were granted in 2005 and 2006 are worth less than was estimated at the time, or have not vested at all.

3.3 What has happened to executive remuneration?

The Commission analysed a number of data sets reporting trends in executive remuneration over the period 1988–2009. Although, as noted, there are difficulties associated with comparing data sets over time, it is unambiguous that executive remuneration has risen strongly over that period. The growth rate depends on the sample of companies considered, and whether the sample includes only CEOs, or all executives. The evidence suggests that executive remuneration grew most rapidly from the early 1990s to around 1999, followed by a period of slower growth, to attain a peak level in 2007.

Executive remuneration has fallen significantly over the past two years in line with declining sharemarket performance, which has reduced incentive-based components of remuneration. Current average levels of executive remuneration (in real terms) are similar to levels that were observed in 2005.

Executive remuneration rose most rapidly in the 1990s

The available evidence suggests that executive remuneration grew fastest from the early 1990s until around 1999. Growth was slower — but still positive — over the period 2000–07 (figure 3.1, table 3.1).

- Over the period 1993–99, average CEO remuneration in ASX100 companies rose by around 13 per cent per year in real terms, and in ASX50 companies by around 16 per cent per year in real terms.
- For the period 2000–07, however, CEO remuneration in ASX100 companies grew more slowly, with average annual real growth rates of around 6 per cent.
- Non-CEO remuneration grew at similar rates to CEO remuneration (appendix B).

Executive remuneration has fallen since 2007

The available evidence suggests that executive remuneration peaked in the 2006-07 financial year. Since then, the decline in the value of equity markets appears to have been reflected in reductions in executive remuneration. Between 2007 and 2009, average total CEO remuneration fell in real terms by approximately:

- 15 per cent per year across the ASX50
- 16 per cent per year across the ASX100
- 11 per cent per year across the ASX300 (Financial Review Executive Salary Database).

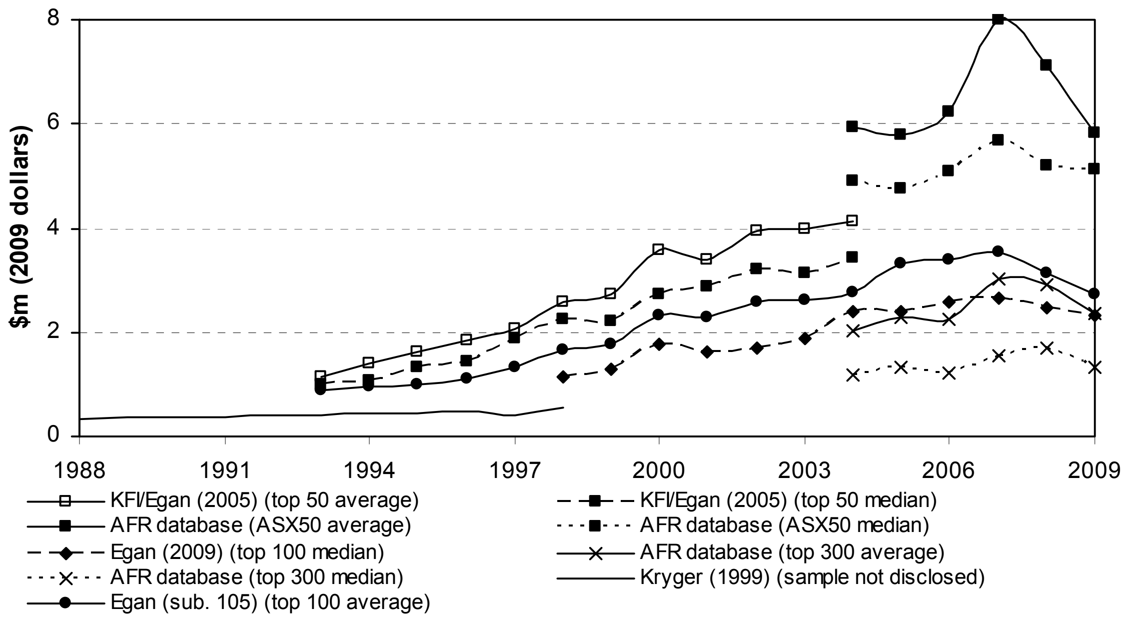
Most of the decline was due to reductions in the value of incentive-based remuneration. For example, across the ASX300:

- average base total remuneration fell less than 1 per cent per year
- average reported short-term incentives fell by approximately 25 per cent per year
- the average estimated value of long-term incentives fell by approximately 13 per cent per year.

The total effect of these reductions means that average total CEO remuneration across the ASX300 in 2008-09 had fallen back to levels comparable to those observed in 2004-05.

The reduction in executive remuneration is particularly evident for the highest paid executives. For example, in 2006-07 there were 11 CEOs of ASX300 companies whose remuneration exceeded $10 million. In 2008-09 there were five. Over the same period, the number of ASX300 CEOs earning less than $1 million increased from 78 to 91.

Figure 3.1 **Australian CEO total remuneration, 1988–2009[a,b]**



[a] Data sources are described in appendix B. [b] Data for Egan (2009) and Egan Associates (sub. 105) include additional data for 2009 that were provided by Egan Associates (pers. comm. 3 December 2009).

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Egan (2009); Egan Associates (sub. 105); Financial Review Executive Salary Database; Korn/Ferry International and Egan Associates (2005); Kryger (1999); Productivity Commission estimates.

There is some evidence that lower executive remuneration may persist in 2009-10, as companies facing slow economic growth freeze or reduce executive remuneration (box 3.4).

CEOs of the top 50–100 public companies are not representative of all listed companies

The terms of reference request the Commission to consider trends in director and executive remuneration at all companies that are disclosing entities under the Corporations Act. Many statements about trends in executive remuneration refer to the remuneration of the CEOs of the 50 or 100 largest companies listed on the ASX. These samples are clearly not representative of all listed company executives, for two reasons:

- CEOs are paid significantly more than other executives in a company.
- Executive remuneration is closely related to company size, which varies hugely (market capitalisation ranges from approximately \$127 billion at the top of the ASX to less than \$100 000 at the bottom).

To address the terms of reference, the Commission has sought to analyse trends in remuneration across the broadest possible sample of companies.

Average remuneration is higher and more volatile than median remuneration

For any group of companies in the available data, *average* executive remuneration is higher and more volatile than *median* remuneration. Both levels and volatility are significantly influenced by the remuneration of a small number of highly paid executives, whose remuneration can vary significantly from year to year, due to the use of incentive-based remuneration.

The data only support broad conclusions about historical trends

Some researchers have used long-run indexes of executive remuneration compiled from a variety of data sources. Given the changing requirements regarding remuneration disclosure, differences in data collection methods, the diverse range of samples available and the reporting of mean and median remuneration, the splicing of data sets is fraught with problems, and is impossible to do in a statistically meaningful way (box 3.5). For this reason, the Commission has not been able to construct a single, long-running time series of remuneration data.

Table 3.1 **Growth rates of executive remuneration**

Average annual growth rate of real executive total remuneration

		Estimated average annual growth rates			
Series	*Period*	*Sample period*	*1993 –99*	*2000 –07*	*2007 –09*
CEOs — total remuneration					
ASX50					
KFI and Egan Associates (2005)					
average	1993–2004	12.4	15.6		
median	1993–2004	11.9	14.4		
Financial Review Executive Salary Database					
average	2004–09	-0.5			-14.7
median	2004–09	0.9			-5.0
ASX100/top 100					
Egan Associates (sub. 105) (average)	1993–2009	7.5	12.5	6.3	-23.6[a]
Egan (2009) (median)	1998–2009	6.3		6.0	-6.2[a]
Financial Review Executive Salary Database					
average	2004–09	1.4			-16.4
median	2004–09	2.9			-11.6
ASX300					
average	2004–09	3.2			-11.4
median	2004–09	2.2			-7.3
Non-CEO executives — total remuneration					
ASX50/top 50					
KFI and Egan Associates (2005)					
median second highest-paid executive	1993–2004	9.4	12.7		
Financial Review Executive Salary Database					
average	2004–09				-11.3
median	2004–09				-7.5
ASX100/top 100					
Egan Associates (sub. 105)					
average of top 5 executives	1993–2008	7.9	12.0		-15.3[b]
Egan (2009)					
median second highest-paid executive	1998–2008	6.5			1.3[b]
ASX300					
Financial Review Executive Salary Database					
average (non-CEO executives)	2004–09				-14.0
median (non-CEO executives)	2004–09				-7.2

[a] Includes data for 2009 that were provided by Egan Associates (pers. comm. 3 December 2009). [b] Refers to the period 2007–08 only.

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Egan (2009); Egan Associates (sub. 105); Financial Review Executive Salary Database; Korn/Ferry International and Egan Associates (2005); Productivity Commission estimates.

Box 3.4 Some companies have reportedly frozen or cut pay for 2009-10

Over recent months, as the economic downturn has reduced company profits, a number of companies have announced pay freezes or reductions in some elements of executive remuneration for 2009-10. The total remuneration received by executives of these companies in 2009-10 will not be known until the second half of 2010. Some high-profile examples include:

- Pay freezes for 2009-10 have been announced by: ANZ (for the top 150 executives) (John 2009), AXA (executives earning over $100 000) (John 2009), AMP (directors, the CEO and senior management) (Murdoch 2009a), Wesfarmers (directors, CEO and other senior managers) (sub. 65), Telstra (top 300 executives) (Colley 2009), and Qantas (management) (AAP 2009).
- Commonwealth Bank of Australia — it was reported that CEO Ralph Norris's base salary will be cut by 10 per cent (incentive-based remuneration arrangements were not altered). The base salaries and short-term incentives of bank staff in middle management roles who earn more than $100 000 were to be frozen from 1 July 2009 (Murdoch and Condon 2009).

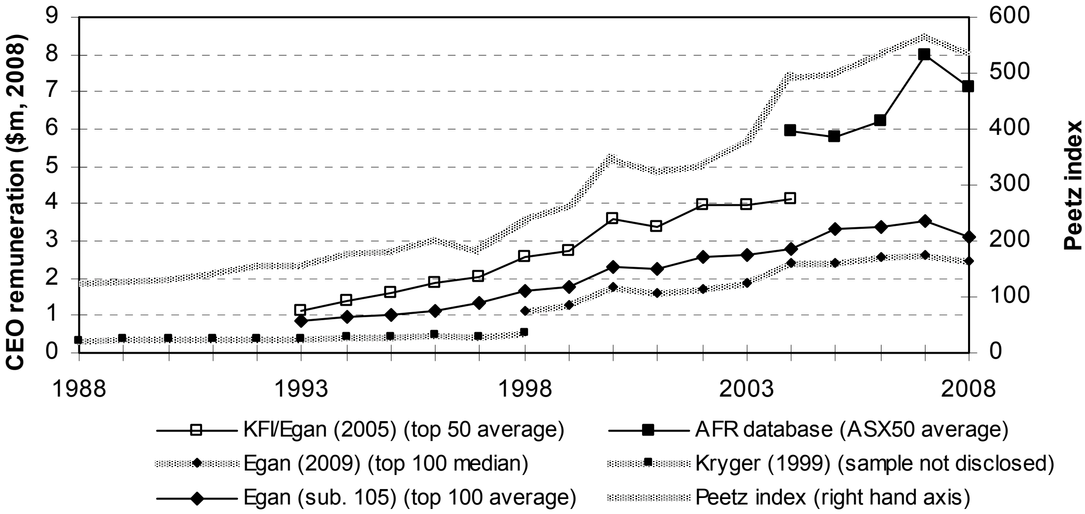
Roberts (2009) reported the results of a survey of the remuneration expectations of executives and senior managers over the coming year. Most of the survey participants were employed by companies with revenues of over $1 billion. The results suggest that the examples above are consistent with a broader trend. Roberts reported that:

- among CEOs and senior executives ('direct reports') whose remuneration reviews had taken place between January and June 2009, 44 per cent had received no increase in fixed remuneration
- among CEOs and senior executives who were scheduled to review their salaries between July and December 2009, 70 per cent anticipated that they would receive no increase in fixed remuneration. Approximately 20 per cent anticipated an increase of less than 3 per cent, while 10 per cent anticipated receiving an increase of between 3 and 3.9 per cent.

Long-run trends in executive remuneration and the ratio of executive remuneration to other employees' earnings are important considerations, but need to be contextualised. Analysis of executive remuneration should take into account factors such as the relationship between executive remuneration and company size, the complex structure of executive remuneration packages and the influence this has on total remuneration, the complexity of executive positions, the different remuneration levels across industry sectors, and the explicit contractual link between executive remuneration and dimensions of corporate performance. Data illustrating these trends are set out in the following sections. An assessment of factors influencing executive remuneration is provided in chapter 4.

Box 3.5 **Splicing the data series will distort underlying trends**

An index of CEO remuneration over an extended period was submitted by David Peetz (sub. 50). The Peetz index was constructed by rebasing and splicing together different sources of data on CEO remuneration, and other 'senior executive' remuneration, including Kryger (1999) (for the period 1988 to 1998) and Egan (2009) (for the period 1998 to 2008). The Peetz index is shown below with other remuneration data series, including Kryger (1999) and Egan (2009).



Compared to the original data, the Peetz index exaggerates somewhat the growth rates of executive remuneration. The average annual compound real growth rates of the original sources and the Peetz index were:

- 1988 to 1998: Kryger (1999) — 5.1 per cent, Peetz — 6.7 per cent
- 1998 to 2008: Egan (2009) — 7.9 per cent, Peetz — 8.4 per cent.

Part of the explanation for the exaggerated growth rates is that the original sources are not based on comparable samples. Kryger (1999) was based on the average remuneration reported by an undisclosed sample of CEOs in a private survey. Egan (2009) was based on the median remuneration of CEOs in the top 100 companies. If the data for 1988 to 1998 included CEOs of companies outside the top 100, it would be expected that the index would exaggerate growth rates after this period.

A second explanation is that the Peetz index was deflated using the consumer price index. The more appropriate deflator for measures of labour cost is the Gross Domestic Product implicit price deflator, which is related directly to the costs of production of goods and services (appendix B). Using the consumer price index instead of the Gross Domestic Product deflator implies higher real growth rates of remuneration, particularly for the periods 1988–99 and 2004–08.

Changes in the structure of executive remuneration

It would appear that until the mid 1990s, most executive remuneration was in the form of a base salary plus some allowances and benefits (such as car allowances). Data from Kryger (1999) suggest that between 1988 and 1996, bonuses usually accounted for less than 10 per cent of total remuneration. Egan Associates stated that by the end of the 1990s 'target annual incentives for senior executives were typically in the range of 20 per cent to 35 per cent of base remuneration' (sub. 105, p. 18). Remuneration packages today contain a larger proportion of incentive-based remuneration (short-term cash bonuses and long-term incentives that are normally paid as equity). In 2008-09, approximately half of ASX300 CEO average remuneration was incentive-based.

Between 2003-04 and 2008-09, average base remuneration for CEOs of ASX300 companies fell by approximately 10 per cent in real terms. At the same time, the value of incentive-based remuneration grew, albeit with significant volatility as company performance was affected by the recent economic downturn. The value of incentive-based remuneration peaked in 2006-07, before declining in the following two years (table 3.2).

In sum, although the value of incentive-based remuneration varies from year to year, there is a general trend toward remuneration packages being weighted more heavily toward incentive-based remuneration, particularly long-term incentives.

Table 3.2 **The structure of ASX300 executive remuneration**[a]

			CEOs			*Non-CEO executives*		
		Units	*Base*	*STI*[b]	*LTI*[c]	*Base*	*STI*[b]	*LTI*[c]
Average value	2003-04	$'000 (2009)	1 324	668	235	670	225	97
	2006-07	$'000 (2009)	1 204	1 038	782	581	423	299
	2008-09	$'000 (2009)	1 194	583	594	554	203	208
Proportion	2003-04	%	59	30	11	67	23	10
	2006-07	%	40	34	26	45	32	23
	2008-09	%	50	25	25	57	21	22

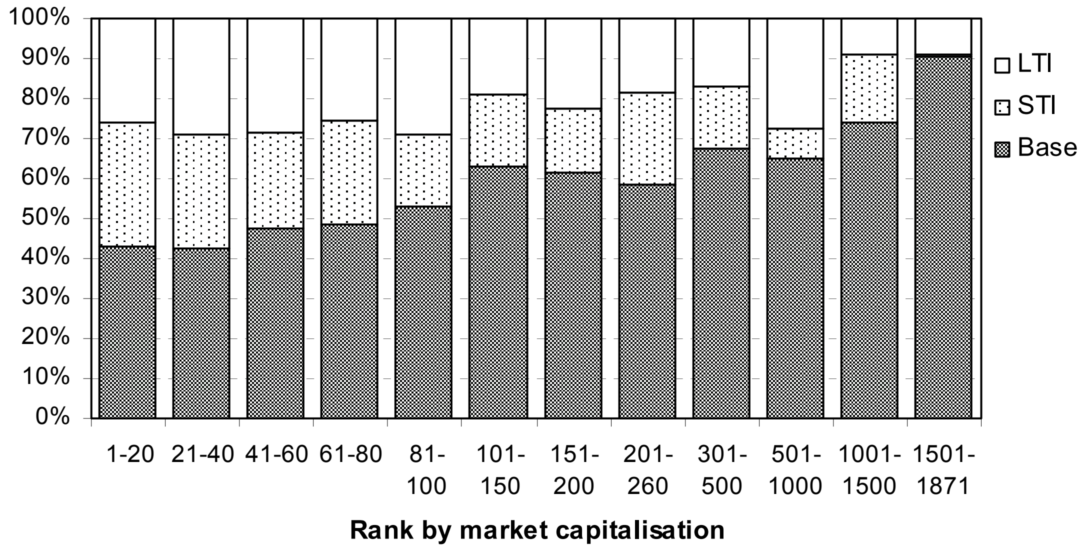
[a] All figures are estimates of the average remuneration of ASX300 executives. [b] Short-term incentive. [c] Estimated value of long-term and equity-based incentives, as reported in annual reports.

Source: Financial Review Executive Salary Database.

Larger companies make greater use of incentive-based remuneration

At the largest companies, the estimated value of incentive-based remuneration generally makes up a larger proportion of total remuneration than at smaller companies (figure 3.2). At a random sample of the smallest companies on the ASX in 2008-09 (companies ranked 1501 to 1871 by market capitalisation), incentive-based remuneration accounted for less than 10 per cent of total remuneration. Greater use of incentive-based remuneration has also meant that the total remuneration of executives at larger listed companies has been more sensitive to the recent declines in company performance.

Figure 3.2 **Structure of CEO average remuneration packages by company size, 2008-09[a]**



[a] From the 301-500 category to the 1501-1871 category the data are based on a random sample of 20 companies in each category. Appendix B describes the sample in more detail. **LTI** Estimated value of long term and equity-based incentives, as reported in annual reports. **STI** Short term incentive.

Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Executive remuneration is closely related to company size

An extensive literature from Australia and overseas consistently finds that company size is the single most significant determinant of the variation in executive remuneration (appendix D). The Commission's own analysis finds the same. Explanations for the relationship are discussed in greater detail in chapter 4, but include:

- the complexity associated with running large companies

- ‘magnification’ effects that increase the benefits to larger companies of employing the most talented CEOs.

Companies have grown greatly over the past 20 years

Market capitalisation is one indicator of the size of a listed company. Between 1989 and its peak in 2007, the market capitalisation of the ASX as a whole grew by approximately 680 per cent in real terms, equivalent to an average annual compound rate of approximately 12.1 per cent. Among the 20 largest companies on the ASX in 2006-07, three had experienced negative real growth since 1989. The rest had at least quadrupled in size, and nine were at least ten times larger (table 3.3). (It should be noted that not all of the companies in the top 20 had been listed since 1989.)

Table 3.3 **Growth of the top 20 companies[a]**

Company name	*Period*	*Initial market capitalisation*	*2007 market capitalisation*	*Real growth*
		$m[b]	$m[b]	%
BHP Billiton	1989–2007	15 143	202 610	1 238
Rio Tinto	1992–2007	9 484	171 844	1 712
News Corporation	1989–2007	5 005	86 283	1 624
Commonwealth Bank	1992–2007	7 312	71 437	877
National Australia Bank	1989–2007	6 989	63 293	806
Telstra Corporation	1998–2007	64 062	57 114	-11
ANZ Banking Group	1989–2007	6 325	55 382	776
Westpac Banking Corporation	1989–2007	7 110	53 153	648
Alcoa	2000–2007	54 636	40 956	-25
Westfield Group	1989–2007	7 110	40 663	472
Woodside Petroleum	1989–2007	2 629	34 685	1 219
Woolworths	1994–2007	3 551	32 597	818
QBE Insurance Group	1989–2007	453	29 365	6 377
Macquarie Group	1997–2007	1 609	21 014	1 206
Suncorp-Metway	1991–2007	295	19 779	6 611
St. George Bank	1993–2007	1 139	18 836	1 554
AMP	1998–2007	26 769	18 404	-31
Wesfarmers	1989–2007	811	17 746	2 087
Coles Group	1989–2007	4 324	17 394	302
Brambles	1989–2007	3 014	17 241	472

[a] 20 largest companies listed on the ASX in 2006-07, by market capitalisation. [b] Expressed in 2007 dollars.

Sources: ABS (*GDP Capital Deflator*, Cat. no. 5206.0); FinAnalysis; Productivity Commission estimates.

A strong relationship between remuneration levels and company size

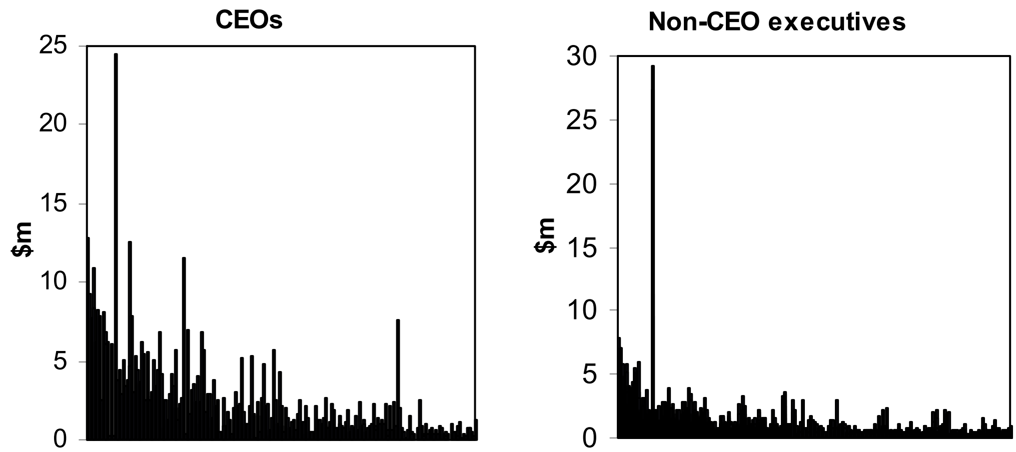
The positive relationship between remuneration and company size can be seen by plotting the total remuneration of executives by the size of their companies (figure 3.3). This shows that, in general, remuneration is higher at larger companies. It also demonstrates the variability in the data, and the difference between the highest and lowest-paid executives. The data can be further broken down to analyse the differences in remuneration across the ASX (figure 3.4).

In 2008-09 the estimated average total remuneration of the CEO of one of the 20 largest companies (by market capitalisation) listed on the ASX was approximately 50 per cent higher than the average remuneration of CEOs of the next 20 largest companies ($7.2 million compared to $4.7 million). CEOs of the next 20 companies were paid substantially less again. In the same year, CEOs at a random sample of companies ranked 1501 to 1871 on the ASX by market capitalisation were paid an average of $264 000.

In conclusion, while there are some 'lumps' in the data, overall there is a strong positive relationship between the remuneration of CEOs and the size of the companies that employ them. A similar relationship holds for non-CEO executives.

Figure 3.3 **Executive remuneration by company size, ASX300 companies, 2008-09[a]**

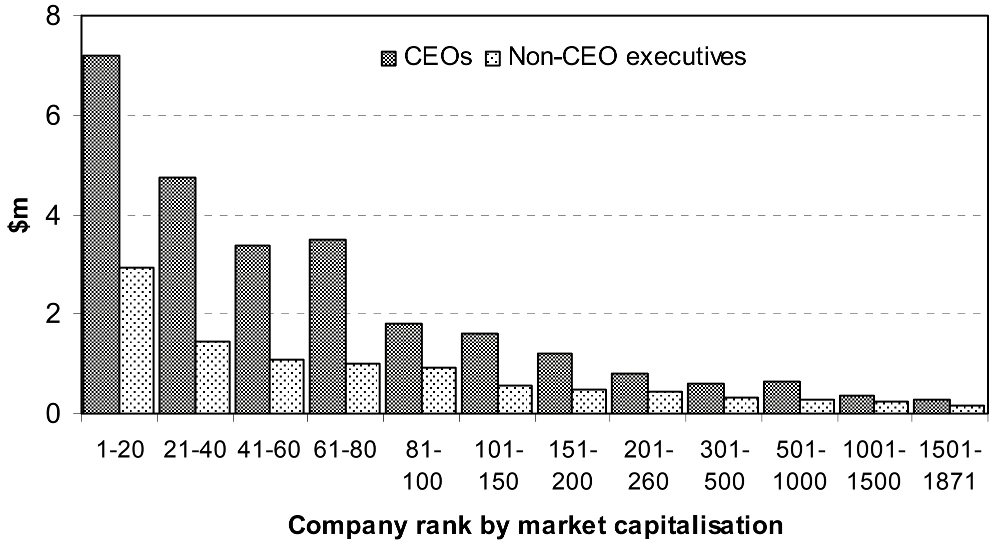
Total remuneration, ASX300 companies ordered by market capitalisation (largest companies on the left)



[a] The highest peaks in both graphs refer to News Corporation executives. The highest-paid CEO in the sample is Rupert Murdoch of News Corporation, whose remuneration was approximately $24.5 million, almost double that of the second highest-paid CEO. The four highest-paid non-CEO executives are all employed by News Corporation. Their remuneration was between $9.6 million and $29.2 million in 2008-09.

Source: Financial Review Executive Salary Database.

Figure 3.4 **Executive remuneration by company size, 2008-09**[a, b]



[a] Average total remuneration. [b] From the 301-500 category to the 1501-1871 category (inclusive) the data are based on a random sample of 20 companies in each category. Appendix B describes the sample in more detail.

Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Statistical correlation is high

Statistical techniques can be used to estimate formally the strength of the relationship between company size and executive remuneration. The Pearson correlation coefficient is a simple and widely-used measure of the relationship between two variables. It takes a value between -1 and 1, depending on the strength of the relationship, and whether it is negative or positive. The Pearson correlation coefficient for ASX300 company CEO total remuneration and company market capitalisation in 2008-09 is 0.64.[3] For non-CEO executives, the coefficient takes a value of 0.44. These values of the Pearson correlation coefficient mean that, in 2008-09, there was a strong correlation between the remuneration of ASX300 executives and market capitalisation. The relationship is stronger for CEOs than non-CEO executives. The relationship between executive remuneration and company size is investigated in more detail in chapter 4.

3 The natural logarithm of market capitalisation was used because of the dispersion in the sample. (The highest market capitalisation in the ASX300 in 2008-09 was approximately $127 billion, the lowest market capitalisation was only $18 million.)

CEO remuneration varies according to job characteristics

Data provided to the Commission by the Hay Group support the proposition that CEOs with more complex roles receive higher remuneration. The 'level' of the CEO is evaluated by the Hay Group with regard to the knowledge and skills required to perform a particular role, and the responsibilities involved.

The three levels are:

- level 'A' — CEO of a diversified company that is mainly focused on domestic operations. Revenue: $750 million–$2.5 billion. Employees: 1500–8000
- level 'B' — CEO of a diversified company with significant international activities. Revenue: $2.5 billion–$8 billion. Employees: 5000–15 000
- level 'C' — CEO of a complex multinational company. Revenue: $8 billion–$15 billion. Employees: Over 15 000.

The data (table 3.4 and appendix B) show that over the period 2001–08:

- CEOs at higher levels consistently earned more than CEOs at lower levels
- total remuneration grew most rapidly for CEOs in levels B and C
- most of the growth in CEO remuneration was accounted for by growth in incentive-based remuneration.

Table 3.4 **CEO median remuneration and growth rates by CEO level**[a]
2008 dollars

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*Average annual real growth rate 2001–08*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000	$'000	%
CEO level A									
Fixed remuneration[b]	996	1 030	1 217	1 344	1 273	1 378	1 186	1 112	1.6
Total remuneration[c]	na	na	na	2 177	1 794	2 147	2 642	2 153	-0.3[d]
CEO level B									
Fixed remuneration[b]	1 455	1 544	1 669	1 716	1 631	1 612	1 645	1 828	3.3
Total remuneration[c]	na	na	na	2 786	3 091	3 519	3 405	4 468	12.5[d]
CEO level C									
Fixed remuneration[b]	1 989	2 153	2 200	2 218	2 256	2 223	2 346	2 590	3.8
Total remuneration[c]	na	na	na	4 387	5 671	6 211	4 763	6 982	12.3[d]

[a] CEO level determined according to the Hay Group job evaluation methodology. [b] Refers to Hay Group 'fixed annual reward' data. [c] Refers to Hay Group 'aggregate reward' data. Due to a change in the way the Hay Group values equity-based incentives, data on aggregate reward is only available on a comparable basis for the period 2004–08. [d] Growth rate is for the period 2004–08. **na** Not available.

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Hay Group (2009); Productivity Commission estimates.

Executive remuneration varies across sectors

The size and structure of executive remuneration packages vary across market sectors. The available data suggest that:

- average CEO remuneration is highest in the telecommunications, finance and consumer sectors, and lowest in the information technology and utilities sectors
- the sectors where incentive-based remuneration accounts for the largest proportion of remuneration are finance and telecommunications, with the lowest proportions in the utilities, consumer and industrial sectors
- over the period 2003-04 to 2008-09, average CEO remuneration grew fastest in the health care, telecommunications and information technology sectors.

Size and growth of executive remuneration packages across sectors

CEO remuneration is much higher in some sectors (finance, consumer and telecommunications) than in others (utilities and information technology) (table 3.5). This could reflect a number of factors, including the nature of the companies, their global reach, and average size.

Over the period 2003-04 to 2008-09, estimates of the value of short-term incentives grew faster than those for base remuneration across most sectors. In all sectors the estimated value of long-term incentives grew faster than base remuneration or short-term incentives (table 3.5). These observations also hold for non-CEO executives (appendix B).

Executive remuneration in the finance sector is highly variable. For example, in 2005-06, average CEO remuneration in the sector was approximately $3.7 million. By 2006-07 this had risen to $5.6 million. In 2008-09, average CEO remuneration in the sector was $3.3 million (all figures in 2009 dollars). This variability is due to the fact that the finance sector makes greater use of incentive-based remuneration than other sectors.

It should be noted that some sectors comprise few companies. For example, in the years for which the Commission was able to access data, there were between one and three telecommunications companies, and between five and eight utilities companies. Results in these industries tend therefore to be driven by a small number of observations.

Table 3.5 **ASX300 CEO remuneration by sector, 2003-04 to 2008-09**

	Average remuneration (2008-09)				*Growth rates (2003-04 to 2008-09)*			
Sector	*Base*[a]	*STI*[b]	*LTI*[c]	*Total*	*Base*[a]	*STI*[b]	*LTI*[c]	*Total*
	$'000	$'000	$'000	$'000	%	%	%	%
Consumer	1 798	766	824	3 388	14	-17	321	35
Finance	1 462	1 098	764	3 324	-13	0	91	13
Telecommunications	1 041	1 485	564	3 089	-24	184	..[d]	64
Industrial	1 137	675	342	2 154	-24	20	96	5
Health care	1 050	539	484	2 073	18	76	313	73
Materials and energy	1 038	348	665	2 051	-18	-11	105	22
Utilities	797	383	300	1 479	-10	-2	194	16
Information technology	520	156	379	1 055	-9	24	296	51

[a] Includes base salary, superannuation and other allowances and benefits. [b] Short-term incentive. [c] Long-term incentive. [d] Growth rate of LTIs cannot be calculated because LTIs were not paid in 2003-04. .. Not applicable.

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Financial Review Executive Salary Database; Productivity Commission estimates.

Trends in remuneration of executives compared to other employees

Several participants commented on the relationship between executive remuneration and average weekly earnings (AWE) (box 3.6). Statements about relative earnings typically focus on ASX50 or ASX100 companies. Analysis of the data shows that:

- the ratio of median CEO remuneration to AWE at the 100 largest companies was approximately 20 times in 1998, rising to approximately 40 times in 2008
- in some industries and at smaller listed companies, the growth of average weekly earnings kept pace with the growth of executive remuneration over the period 2003-04 to 2008-09
- after peaking in 2006-07, the ratio of executive remuneration to AWE in 2008-09 had returned to the levels observed in 2004-05
- executive remuneration grew more rapidly than the remuneration of other professionals, but the difference was not as large as the difference between the growth rates of executive remuneration and AWE
- up to the peak in executive remuneration in 2006-07, most of the difference between the growth rates of executive remuneration and AWE was accounted for by incentive-based remuneration paid to executives.

Box 3.6 **Executive remuneration and average weekly earnings: participants' assessments**

Some participants commented on the relationship between executive remuneration and the earnings of other employees. The Australian Council of Trade Unions stated:

> Between 1990 and 2005, the average cash remuneration of CEOs in top 50 listed Australian companies … has ballooned from a multiple of 18 times average full-time earnings to a multiple of 63. (sub. 82, p. 1)

This figure is based on Shields (2005). It was also used in submissions from the Construction, Forestry, Mining and Energy Union (sub. 78) and the Finance Sector Union (sub. 39). Along similar lines, David Peetz stated:

> The growth in CEO pay, of something around 470 per cent over the period 1971–2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period. (sub. 50, p. 3)

Wage relativities for CEOs are largest at the largest companies

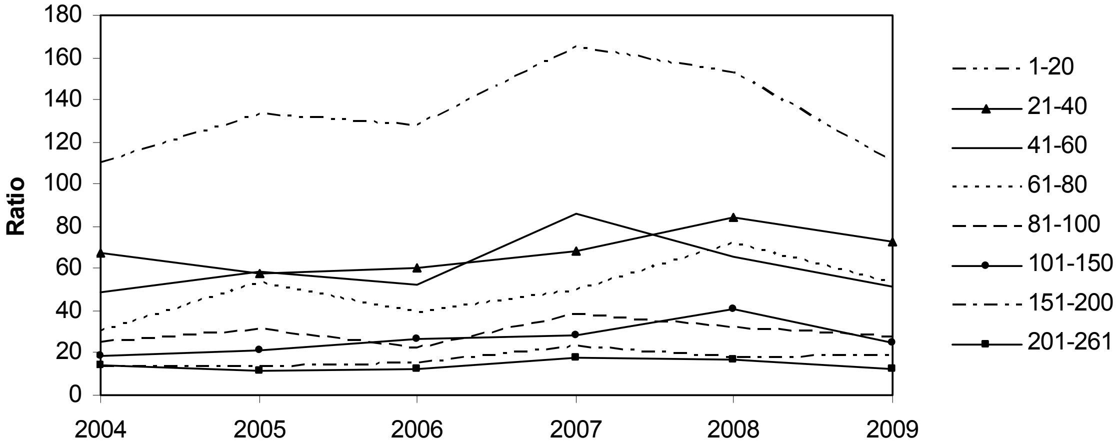
The differential between estimated CEO total remuneration and AWE is significantly greater for the top 20 companies in the ASX300 (figure 3.5). However, since the 2006-07 peak in executive remuneration, the ratio of top 20 CEO average remuneration to AWE has declined significantly (from approximately 165 times AWE to 110 times).

Analysis of remuneration ratios suggests that the very high executive salaries cited in the media are mainly a large company phenomenon. For example, in a random sample of companies ranked 1501 to 1871 on the ASX in 2008-09, average reported CEO remuneration was approximately four times AWE. Similar results hold for non-CEO executives (appendix B).

The difference between executive remuneration and average earnings is related to the responsibilities of the executive

The complexity of executive positions varies according to the characteristics of the job, the responsibility assigned to the executive and the knowledge and skills required. Hay Group data on the remuneration of CEOs, broken down into three categories using the Hay Group's job evaluation methodology, show that those CEOs who are in roles that require more skills, and are more able to influence the performance of their company, earn significantly more than others, and have higher salaries relative to AWE (figure 3.6).

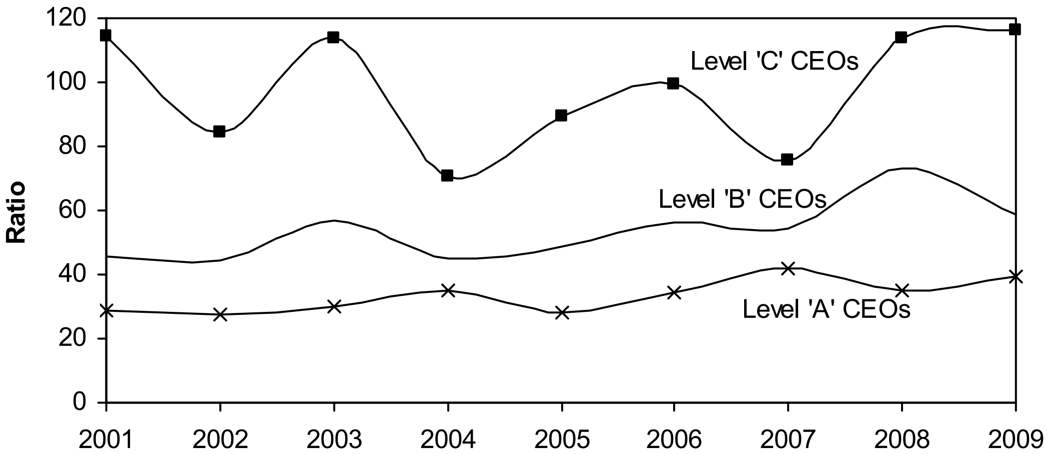
Figure 3.5 **Ratio of CEO remuneration to AWE varies by company size, 2003-04 to 2008-09[a, b]**



[a] Companies ranked in order of market capitalisation in each year. [b] The sample does not include every company in the ASX300. Depending on the year in question, the sample includes between 242 and 261 companies from the ASX300 (appendix B).

Sources: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0); FinAnalysis; Financial Review Executive Salary Database; Productivity Commission estimates.

Figure 3.6 **CEO remuneration relative to AWE according to CEO level, 2001 to 2009[a, b]**



[a] CEO level based on Hay Group job evaluation methodology. [b] Median total remuneration including fixed remuneration (base salary, superannuation and allowances), short-term incentives and long-term incentives.

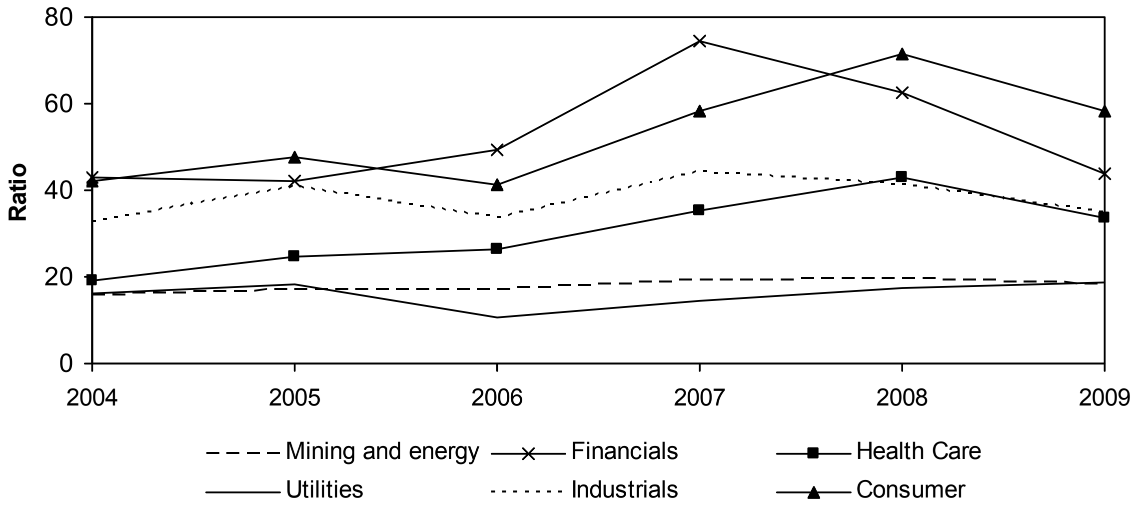
Sources: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0); Hay Group (2009); Productivity Commission estimates.

Average earnings have kept pace with executive remuneration in some industries

Over the past six years, AWE in some sectors grew at similar rates to executive remuneration (figure 3.7). This was particularly the case for the utilities sector, and the materials and energy sector (which includes mining). Executive remuneration in the finance sector grew rapidly between 2004-05 and 2006-07. However, in 2008-09 significant reductions in CEO average remuneration in the finance sector meant that the ratio of average CEO pay to AWE in the sector had returned to the same ratio as was observed in 2004-05 (44 times).

One explanation for the different wage relativities across industries relates to the demand for non-executive labour relative to that for executives. In the mining sector, strong demand for skilled labour and shortages in supply drove wage increases across the board, contributing to the relatively stable relationship of executive remuneration to AWE in this sector. Slower earnings growth among employees in other sectors (such as retail trade, hospitality, and health and community services) might equally have been due to weaker labour demand or a larger supply of workers with the skills demanded in those industries.

Figure 3.7 **Ratio of average CEO total remuneration to AWE by industry sector, 2003-04 to 2008-09[a]**



[a] The series show the ratio of CEO total remuneration to the average weekly earnings of employees in the sector. The derivation of these series are explained in greater detail in appendix B.

Sources: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0); Financial Review Executive Salary Database; Productivity Commission estimates.

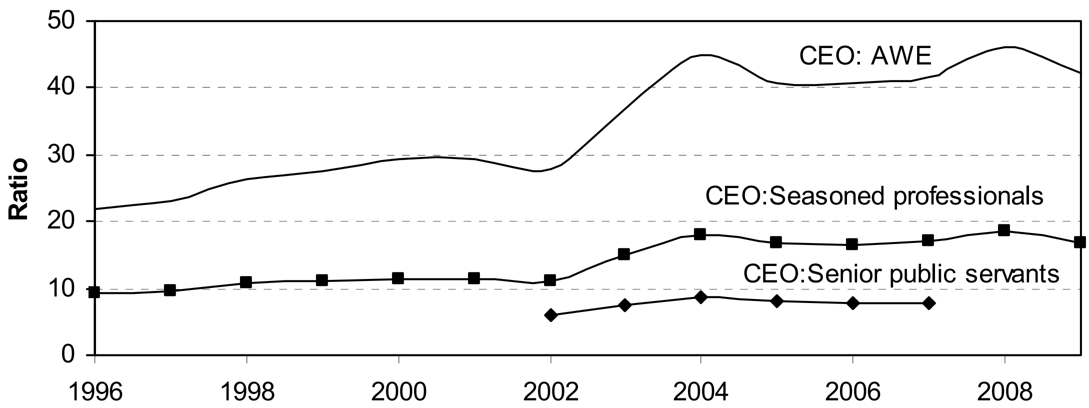
Less divergence between executives and professionals

The ratio of executive remuneration to that of professionals has grown, but at a slower rate than that to average earnings. The Hay Group stated:

> The ratio of CEO pay to pay of junior professionals has remained constant over recent years at approximately 16:1 for fixed remuneration and 20:1 at fixed plus annual incentives. (sub. 84, p. 8)

The limited data that are available suggest that the slower growth of the ratio of average CEO remuneration to the average remuneration of professionals is evident for both the public and private sectors (figure 3.8).

Figure 3.8 **Ratio of CEO remuneration[a] to AWE and other professionals[b]**



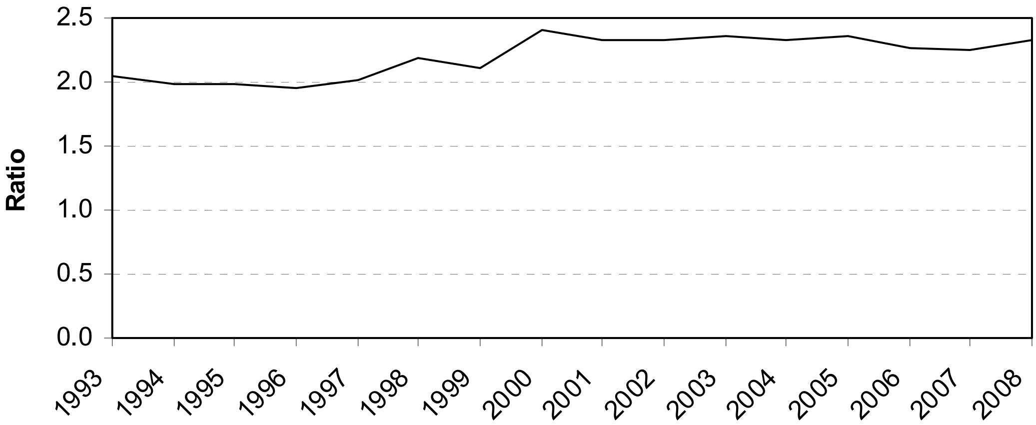
[a] Refers to the remuneration of 'Level B' CEOs, not including long-term incentives. [b] Appendix B includes a definition of 'seasoned professionals'. 'Senior public servants' refers to Australian Public Service Senior Executive Service Band 3.

Sources: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0); Hay Group (2009); Productivity Commission estimates.

The ratio of CEO remuneration to other executives' remuneration

The data suggest that over the period 1993–99, the ratio of CEO remuneration to the average remuneration of other executives remained relatively constant at approximately 2:1. Over the period 2000–08, the ratio rose somewhat, being around 2.4:1 in most years (figure 3.9).

Figure 3.9 **Ratio of CEO remuneration to other executives[a], top 100 companies**



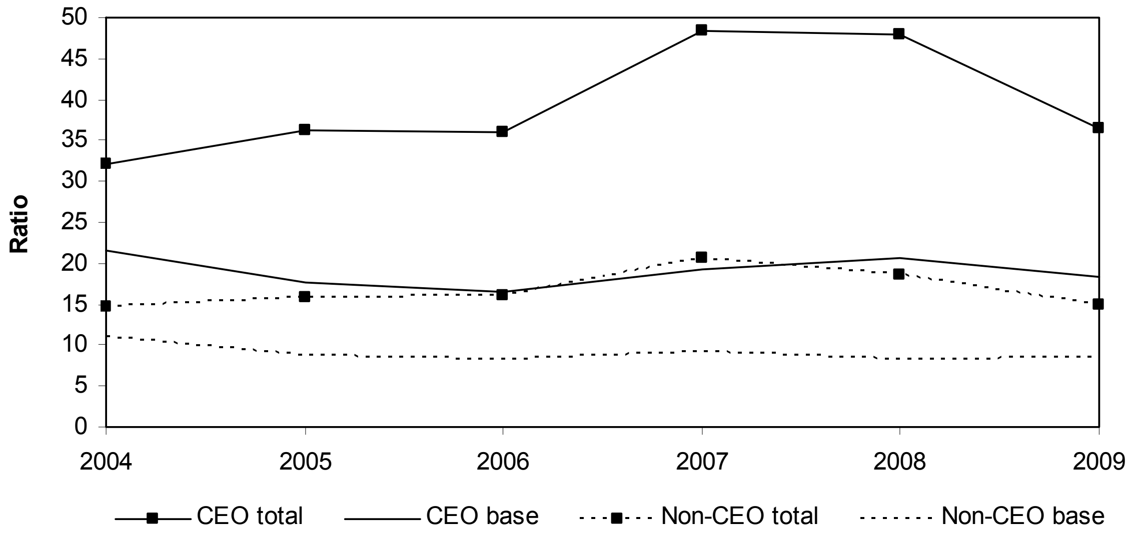
a Data refer to the average remuneration of CEOs and the average remuneration of 'top 5' executives at the largest 100 companies by market capitalisation.

Source: Egan Associates (sub. 105).

The growing gap between executive remuneration and AWE was due to growth in incentive-based remuneration

The growth in executive remuneration relative to AWE over the period 2003-04 to 2007-08 was entirely accounted for by the growth of incentive-based remuneration (figure 3.10). Base remuneration was constant or declining over the period, whereas the value of incentive-based remuneration (including the estimated value of long-term incentives) grew rapidly. The value of the incentive-based components of remuneration fell significantly in 2008-09, leading to a reduction in the ratio of executive remuneration to AWE.

Figure 3.10 **Ratio of average executive earnings to AWE**



Sources: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0); Financial Review Executive Salary Database; Productivity Commission estimates.

3.4 What has happened to directors' remuneration?

The Government has asked the Commission to examine the remuneration of both executives and directors. These two groups are not mutually exclusive, as some directors are drawn from a company's management. Generally, executive directors (for example, the CEO) are not paid additional fees for serving on boards, as this is assumed to be part of their executive responsibilities. Non-executive directors (NEDs) do not perform other services for the company and are generally paid solely for board duties. Hence, this section focuses on payments made to NEDs.

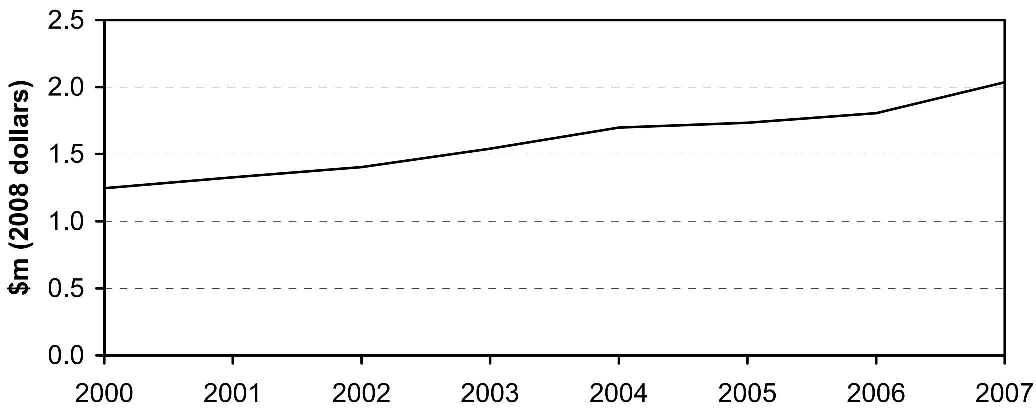
NEDs' remuneration is much less complicated than executive remuneration. They are typically paid a fixed sum in cash, with an opportunity (or requirement) in some companies to sacrifice a portion of their fee to buy shares in the company. Incentive-based pay for non-executive directors is uncommon and is not considered good practice (chapter 7).

Companies must obtain shareholder approval for payments to NEDs. This takes the form of a binding vote on the 'fee pool' — a dollar ceiling imposed on companies for their total provision of (non-executive) directors' fees. The board decides how to allocate the fee pool among the chair and other NDEs (chapter 6).

Between 2000 and 2007, the average fee pool at the top 100 listed companies increased by about 63 per cent in real terms (figure 3.11). In 2007, the average fee pool for ASX100 companies was approximately $1.9 million, which compares to average CEO total remuneration within that group of over $4.5 million (Korn/Ferry International and Egan Associates 2008; Financial Review Executive Salary Database). Clearly, NEDs are paid considerably less than CEOs.

Board chairs generally receive significantly higher remuneration than other NEDs. In 2008, the average remuneration of chairs of top 100 companies was around $400 000, and average NED remuneration was around $175 000 (Egan Associates, sub. 105). Between 1993 and 2008, the average remuneration of chairs and NEDs in this group increased by approximately 215 per cent in real terms, or around 8 per cent per year (figure 3.12).

Figure 3.11 **ASX100 companies average directors' fee pools, 2000–07**

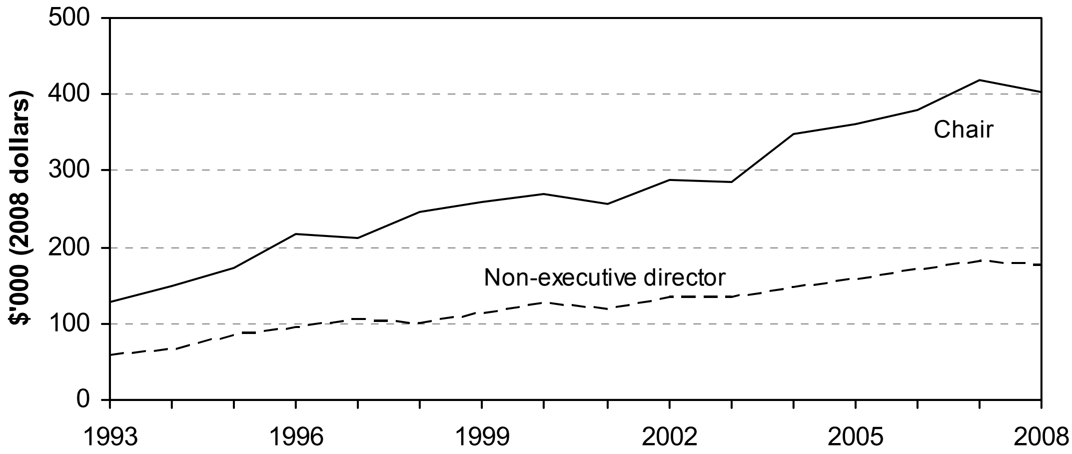


Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Korn/Ferry International and Egan Associates (2008).

As with executive remuneration, there is a relationship between company size and the remuneration of directors. The average remuneration of chairs and NEDs is significantly higher at larger companies (figure 3.13).

Some companies pay NEDs additional fees for chairing or serving on board subcommittees (such as the audit, remuneration or nomination committees). However, there are no consistent rules or practices relating to payment for committee work. (Appendix B sets out the board committee remuneration practices of a sample of companies.)

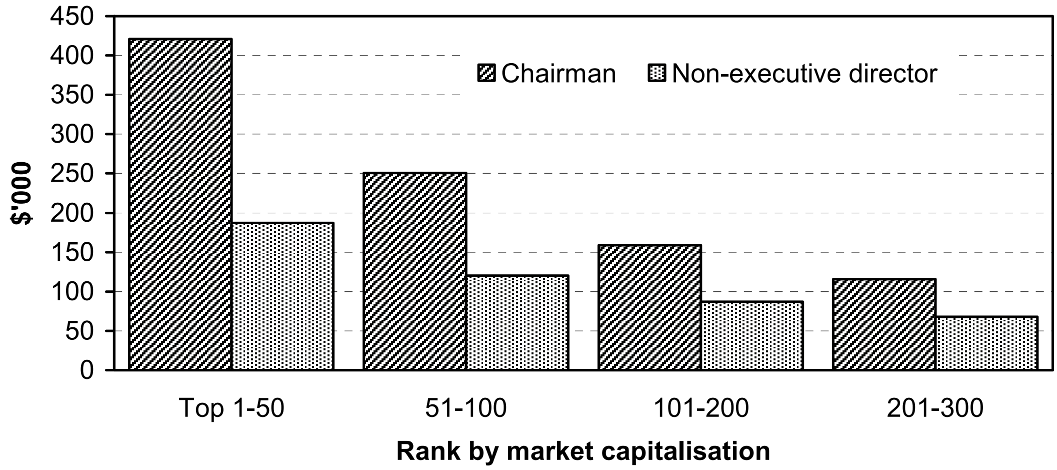
Figure 3.12 **ASX100 average company chair and non-executive director[a] remuneration, 1993–2008**



[a] Refers to the five highest-paid non-executive directors.

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Egan Associates (sub. 105).

Figure 3.13 **Directors' remuneration[a] and market capitalisation[b], 2007**



[a] Average remuneration. [b] Market capitalisation as at 30 June 2008.

Source: Korn/Ferry International and Egan Associates (2008).

3.5 Remuneration and corporate performance

The Commission was also asked to consider the relationship between remuneration and corporate performance. Because directors' remuneration is typically not directly linked to corporate performance, this section focuses on executives. There are a number of issues that complicate the analysis, including: the definition of corporate performance; determining which components of remuneration are expected to be linked to company performance; and the effect of corporate performance on the portion of executives' wealth that is held in company shares.

There are many ways to measure corporate performance

One of the challenges in attempting to identify the relationship between remuneration and corporate performance is determining appropriate measures of corporate performance itself. Listed companies use a range of measures of performance when designing executive remuneration (box 3.7). These include some publicly-disclosed measures (such as accounting measures of financial performance, or measures that are linked to the company's share price), but also some measures that are not disclosed, often for strategic reasons.

Researchers investigating the relationship between pay and corporate performance are limited to using publicly-available indicators. Some have used regression analysis to identify statistical relationships between indicators of corporate performance and executive remuneration. This approach is reasonable provided the data are adequate and the indicators correspond with those used by companies to determine executive remuneration.

However, many of the performance indicators used by companies are not publicly disclosed. Furthermore, it is not necessarily the case that they are correlated with the performance indicators used by researchers. There are circumstances (such as the recent downturn) where an executive might be performing well against targets set by the board, though the company is not performing well in terms of a particular accounting or market-based indicator. Statistical analysis that attempts to identify a numerical relationship between remuneration and the chosen indicators of corporate performance could lead to incorrect conclusions.

Box 3.7 **How do companies measure corporate performance for remuneration purposes?**

Submissions detail a range of indicators of corporate performance that different companies use when setting executive remuneration.

For example, Woolworths stated:

> … short-term incentives are payable upon the achievement of Woolworths' financial key result areas (KRAs), as well as a component for non-financial or individual performance. Generally the components are weighted 70% to financial KRAs and 30% to non-financial or individual performance.
>
> The financial KRAs may be measures such as Sales, Earnings Before Interest and Tax (EBIT), Return on Funds Employed (ROFE) and Cost of Doing Business (CODB). Non-financial measures may include objectives such as reducing staff turnover rates and performance in areas such as safety, shrinkage and food safety compliance ratings. (sub. 91, p. 3)

Egan Associates stated that:

> … a reasonable proportion of named executives in Annual Reports are receiving annual incentives on the basis of business group, divisional or regional performance outcomes, not the corporate result. (sub. 105, p. 20)

Other submissions identified performance indicators including 'health and safety … and performance against cost and schedule of capital projects' (BHP Billiton, sub. 45, p. 4) and 'customer satisfaction, environmental/sustainability practices and employee engagement' (Australian Bankers' Association, sub. 70, p. 6).

Not all remuneration is *meant* to be linked to performance

Of the three main components that constitute a typical executive remuneration package (base salary, short-term and long-term incentives), only the incentive-based components are contractually linked to individual and corporate performance. Base salary is paid to executives regardless of corporate performance, and is explained to a significant extent by the size of the company, the complexity of the role and the executive's other opportunities for employment. However, annual increments in base salary could be linked to performance. Accordingly, analysis of the relationship between remuneration and corporate performance should focus on incentive-based remuneration.

Previous sections have detailed the difficulties associated with using the publicly-reported values of long-term incentives (based on accounting estimates). Long-term incentives are often linked to corporate performance in subsequent years. Disclosed grants of equity-based long-term incentives could under- or overstate the amount that is received by the executive. The realised value will depend on whether performance hurdles are met, and on the company's share price performance in the intervening period. The reported values of short-term incentives are increasingly subject to the same complications as an increasing number of companies opt to defer payment of some short-term incentives subject to performance in subsequent years (box 3.8). The implication is that statistical analysis that attempts to identify relationships between incentive-based remuneration and performance indicators in a single year could lead to spurious conclusions.

Box 3.8 **Short-term incentives are complex**

Short-term incentives are typically paid as cash bonuses for performance against targets in a given year. Two issues complicate analysis of the relationship between short-term incentives and corporate performance.

The first is that companies only report the incentive that was paid, not the total amount the executive could have received if he or she had met all of their performance goals (the 'target bonus'). If the target bonus was reported, it would be possible to measure how well the executive had performed against the targets that were set for them. Without knowing how much the executive could have received in short-term incentives, the reported data only convey part of the relationship between short-term incentives and performance.

The second complication arises from the increasingly-common practice of deferring short-term incentives. Many companies have instituted schemes to withhold part of a performance bonus that was granted (and reported). The withheld portion can only be claimed if the executive meets performance targets in subsequent years. This practice is becoming widespread. Macquarie Group noted:

> The 2009 Ernst and Young Executive and Board remuneration report stated that 52 per cent of the 46 companies they surveyed in the ASX50 had mandatory variable short-term incentive deferral mechanisms. This was an increase from 32 per cent in the previous year. In aggregate, across the ASX200 companies, the percentage of companies with mandatory deferral increased from 21 per cent to 31 per cent. (sub. 52, p. 8)

Both of these practices are likely to distort the statistical relationship between corporate performance and the reported value of short-term incentives.

Corporate performance also affects executives' wealth

Executives often accumulate significant holdings of equity in the companies they work for. (Tables 4.2 and 4.3 set out examples of holdings valued at several million dollars.) As such, a significant proportion of executives' wealth is aligned to the performance of the company. Analysis of the relationship between remuneration and corporate performance therefore only captures one element of the alignment. Even in cases where there appears to be no statistical relationship between remuneration and corporate performance, an executive may be experiencing significant changes in their wealth, related to the company's performance (see chapter 4).

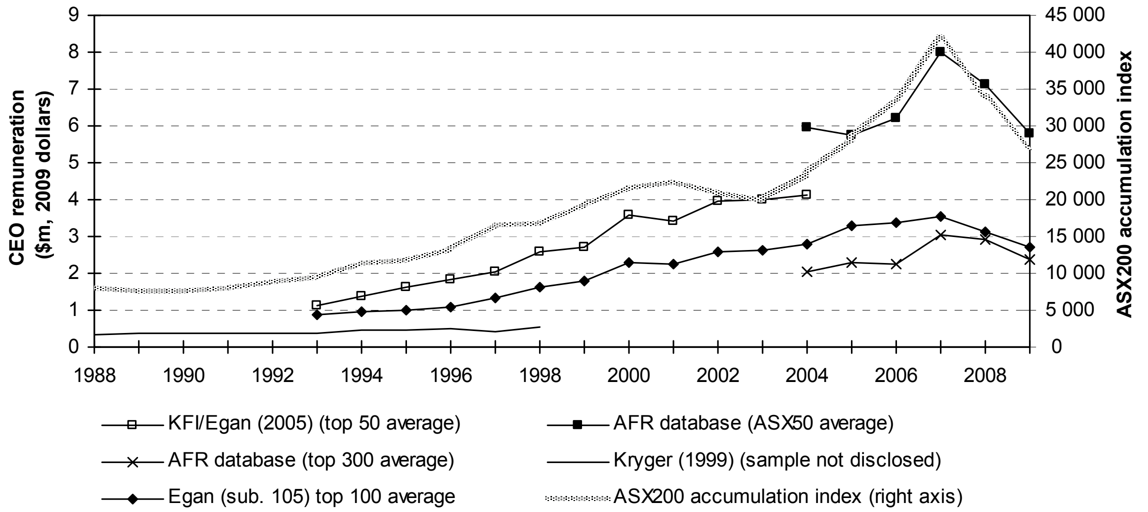
Executive remuneration has grown at similar rates to company performance at an aggregate level

There is some evidence that the trend growth of executive remuneration over the past 20 years has been broadly consistent with the aggregate performance of the 200 largest Australian listed companies. In particular, the reduction in shareholder wealth over the past two years appears to have been matched by a significant reduction in CEO remuneration, particularly at the largest companies.

The ASX200 accumulation index measures the total pre-tax return to investments in the 200 stocks that are part of the index, including both price changes (capital growth) and dividends (income). The evidence on executive remuneration suggests that, on average, the real growth rates of various measures of executive remuneration have been comparable in magnitude to the growth rate of the ASX200 accumulation index (figure 3.14, table 3.6).[4] Statistical measures provide further evidence of a link between corporate performance and executive remuneration: between 2003-04 and 2008-09, the correlation coefficient of the ASX200 accumulation index and average CEO remuneration at ASX50 companies was 0.88. For ASX300 average remuneration, the correlation coefficient was 0.83. This supports the proposition that executive remuneration is sensitive to corporate performance.

[4] The Commission used the ASX200 accumulation index because it was the most readily-available index of ASX performance. Standard and Poor's also compile an accumulation index for the ASX300, but the Commission was not able to access the full data series. Analysis of the ASX200 accumulation index and figures provided by CRA Plan Managers (sub. 103) indicate that the ASX300 accumulation index grew at an almost identical rate to the ASX200 accumulation index between 1999 and 2008.

Figure 3.14 **CEO remuneration and corporate performance, 1988–2009**



Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Economagic.com (nd); Kryger (1999); Korn/Ferry International and Egan Associates (2005); Egan (sub. 105); Financial Review Executive Salary Database; Productivity Commission estimates.

Table 3.6 **Growth of CEO remuneration versus the ASX200 accumulation index, 1988–2009**

Data source	*Period*	*CEO remuneration average annual growth rate*	*ASX200 accumulation index average annual growth rate*
		%	%
Kryger (1999) (undisclosed sample)	1988–98	5.1	7.5
Egan (2009) (top 100 median)	1998–2008	7.9	7.3
KFI/Egan (2005) (top 50 average)	1993–2000	17.8	12.2
KFI/Egan (2005) (top 50 median)	1993–2000	15.4	12.2
AFR Database (ASX300 average)	2004–07	14.3	21.2
	2007–09	-11.4	-19.5
AFR Database (ASX50 average)	2004–07	10.3	21.2
	2007–09	-14.7	-19.5

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Economagic.com (nd); Kryger (1999); Korn/Ferry International and Egan Associates (2005); Egan (2009); Financial Review Executive Salary Database; Productivity Commission estimates.

Identifying relationships between executive remuneration and individual indicators of corporate performance is difficult

Researchers have attempted to identify relationships between executive remuneration and specific indicators of corporate performance. Some have examined the performance of individual companies over time, and sought to determine whether executive remuneration has changed in response to changes in the company's performance. Others have analysed large samples of companies simultaneously to attempt to identify whether, in a given year, a change in a certain performance indicator is linked to a change in remuneration on average. Neither approach has provided conclusive evidence of an observable link between remuneration and the chosen indicators of corporate performance across all companies. In interpreting these results (or the absence of results) it is important to be aware of the weaknesses of such analytical frameworks when investigating the relationship between remuneration and corporate performance.

Company-by-company analysis

RiskMetrics analysed the remuneration of the 10 highest-paid CEOs in 2007 to determine whether there was a relationship between remuneration and corporate performance. The analysis consisted of a series of case studies in which the growth of each CEO's remuneration over the period 2001–07 was compared to the company's share price performance, its return on assets and total shareholder return over the previous one and three years (Australian Council of Super Investors, sub. 71, attachment 1). (Some CEOs in the sample had not served for the full period under analysis.) The case studies showed some evidence of a relationship between CEO remuneration and corporate performance. For example, in several cases, growth in total remuneration was consistent with the company's share price performance and/or total shareholder return. And in many cases, trends in incentive-based remuneration were consistent with trends in return on assets.

Regression analysis

Regression analysis is a statistical technique used to identify causal relationships in larger samples of data. Researchers have used regression analysis to determine whether there is a statistically significant relationship between the reported remuneration of individual executives and various publicly-available measures of company performance. The performance measures used include accounting measures (such as sales, profit and return on equity) and market-based measures (such as share price and total shareholder return).

Regression analysis is a useful tool, provided the data in the sample under analysis are representative of the population. In the case of executive remuneration, this assumption may be violated for reasons outlined above, including:

- the reported value of incentive-based remuneration is not necessarily the same as the realised value

- not all remuneration is intended to be linked to corporate performance
- indicators of corporate performance might not reflect the measures used by companies in determining remuneration packages.

A further problem is that the data used do not include executives who were dismissed following poor corporate performance (and whose remuneration therefore falls to zero). The exclusion of these executives from the analysis means that it ignores one of the most significant ways in which remuneration is linked to corporate performance.

Along similar lines, the regression framework is not well suited to analysing remuneration packages where significant proportions of executive remuneration are subject to performance conditions that can only be met in subsequent years. Under the commonly-used regression framework, all remuneration is treated as if it were cash received in the year it is reported. This approach will tend to understate the extent to which the value of remuneration that is actually received by executives is linked to corporate performance.

These issues could lead to conclusions that are at odds with the true relationships between remuneration and corporate performance.

The conclusions in the Australian literature reflect the difficulties in using regression analysis. Some researchers identified statistically significant relationships between executive remuneration and one or more measures of corporate performance (Doucouliagos, Haman and Askary 2007; Merhebi et al. 2006; O'Neill and Iob 1999). Others found no evidence of a relationship between pay and performance (Izan, Sidhu and Taylor 1998; Capezio 2008). (Appendix D includes a more detailed review of the empirical research.)

The Commission carried out some regression analysis of its own, examining the relationship between CEO remuneration and various measures of corporate performance over the period 2003-04 to 2007-08 (table 3.7). The results support the previously-identified positive relationship between remuneration and market capitalisation. They also suggest that the proportion of total remuneration that is incentive-based tends to be larger at larger companies.

However, it proved difficult to draw conclusions from the regression analysis about the relationship between remuneration and indicators of corporate performance. The results suggest that the three chosen indicators of corporate performance (total shareholder return, profit growth and return on equity) are related to some of the measures of executive remuneration, but not to all. In some cases there is a positive statistical relationship between remuneration and corporate performance (for example, there was a positive relationship between long-term incentives and return on equity and between long-term incentives and both total shareholder return and profit growth, when the performance variables are lagged one year). In other cases, the statistical relationship is negative (for example, between some measures of remuneration and total shareholder return).

The analysis shows that the chosen indicators of corporate performance explain only a small part of the variation in executive remuneration. The value of the coefficient of determination (R^2) for each of the statistical models suggests that variations in market capitalisation and in the chosen performance indicators explain less than half of the variation in executive remuneration (and in some cases as little as 10 per cent). Further analysis suggests that most of the explanatory power comes from variations in market capitalisation (appendix B), and the corporate performance indicators add little explanatory power to the models. This suggests that there are other variables that explain more of the variation in executive remuneration. Two types of variables that have been identified in the literature as having significant explanatory power in such analysis deal with the effects of share price volatility on remuneration, and the effects of share price changes on executive wealth (box 3.9), but the Commission was unable to include these variables in its analysis because of data limitations.

Box 3.9 **Share price volatility and executive wealth**

Regression analysis using US data suggests that the sensitivity of an executive's pay to corporate performance declines with the volatility of company performance (Aggarwal and Samwick 1999). This finding has been corroborated by subsequent studies including Merhebi et al. (2006) (for Australia) and Clementi and Cooley (2009) (for the US). The relationship is explained by the tradeoff between providing incentives to executives (by making pay contingent on performance), and the need to avoid imposing too much risk on a risk-averse executive. Consequently, estimates of pay-performance sensitivities that do not consider the variance of company performance are likely to be biased downwards.

Other authors have found that the relationship between corporate performance and executives' financial rewards is stronger when the analysis includes the market value of shares and options, the expected value of future cash payments, and the total value of shares granted, in addition to cash and bonus pay (Clementi and Cooley 2009). Along similar lines, Hall and Liebman (1998) found that CEO pay became increasingly more sensitive to corporate performance in the 1980s and 1990s. They considered that this was mainly due to the increased issuance of options to US executives in the 1980s and 1990s (which explicitly ties an executive's wealth to that of shareholders).

Table 3.7 Models of the relationship between CEO pay and performance 2003-04 to 2007-08 — coefficient estimates

	Independent variables							
Dependent variable	Log (market capitalisation)	TSR[a]	TSR_{t-1}	NPAT $growth_t$[b]	NPAT $growth_{t-1}$	ROE_t[c]	ROE_{t-1}	R^2
Log(base salary)	0.282***	-0.127**	0.005	-0.012	-0.004	-0.067	0.034	0.16
Log(total remuneration)	0.462***	-0.162**	0.044	-0.017*	0.008	-0.053	-0.040	0.28
Log(STI)[d]	0.572***	-0.098	0.053	-0.007	0.001	-0.219	-0.569	0.46
Log(LTI)[e]	0.557***	-0.424***	0.083**	-0.002	0.006	0.196*	0.363	0.38
STI as a proportion of base salary	0.446***	-0.024	0.032	-0.006	0.011	-0.022	-0.750	0.12
LTI as a proportion of base salary	0.188***	-0.087	0.137***	-0.005	0.014*	-0.013	0.060	0.10

* Significant at the 10 per cent level. ** Significant at the 5 per cent level. *** Significant at the 1 per cent level. [a] Total shareholder return. [b] Growth of net profit (after tax). [c] Return on equity. [d] The natural logarithm of short-term incentives. [e] The natural logarithm of the estimated value of long term and equity-based incentives, as reported in annual reports.

Sources: Financial Review Executive Salary Database; FinAnalysis; Productivity Commission estimates.

The regression framework could potentially be improved by examining the relationship between changes in corporate performance and changes in executive remuneration from year to year. The Commission's regression framework used cross-section data. That is, the value of executive remuneration in a given year was compared with corporate performance indicators in the same year (or in previous years). Both the company-by-company analysis undertaken by RiskMetrics and aggregate indicators of remuneration and performance (such as the ASX200 accumulation index and time series of average and median executive remuneration) suggest that there is a relationship between changes in remuneration and changes in performance. A regression framework that does not capture this kind of relationship will therefore tend to understate the relationship between remuneration and corporate performance.

However, while it is possible to suggest changes to the modelling framework that might increase its explanatory power, the fact remains that the available data on executive remuneration and corporate performance limit the ability of the regression framework to explain variation in executive remuneration.

3.6 Executive remuneration overseas

Limited data are available on the remuneration of executives in other countries. International comparisons are also complicated by factors including: differences in executive roles and responsibilities across countries; reporting requirements that are not consistent across countries; differences in the way executive remuneration packages are structured; differences in company size and market capitalisation; currency fluctuations and differences in the purchasing power of currency across countries (and hence the cost of living); and differences in tax systems. However, it is possible to reach some conclusions, notably:

- executive remuneration in Australia appears to be well below that observed in the United States, which is a significant 'outlier' to the rest of the world
- executive remuneration in Australia appears comparable to that in smaller European countries.

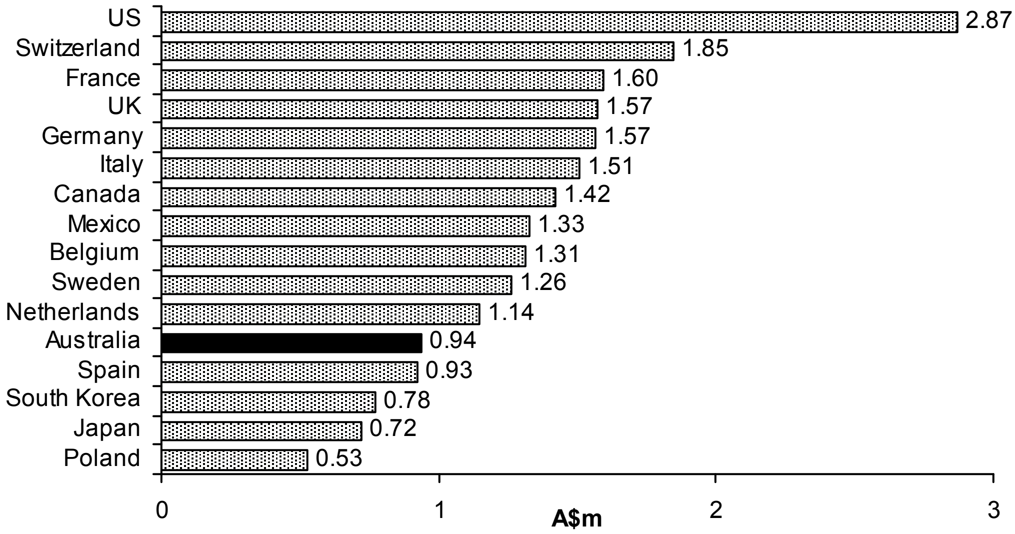
Australia compared to other countries

CGI Glass Lewis and Guerdon Associates provided data on the total remuneration of CEOs of companies with a market capitalisation of US$500 million in 2006 (figure 3.15). This equates to a company ranked around 150 in the ASX by market capitalisation in 2006. The data indicate that the remuneration of CEOs of Australian companies of this size was similar to the remuneration of CEOs of companies of a similar size in Spain and some smaller European countries (Belgium, Sweden and the Netherlands). CEOs of US companies were paid almost three times the remuneration of CEOs of similar-sized Australian companies. The data for Australia were broadly consistent with other Australian data used by the Commission.[5]

[5] Data from the Financial Review Executive Salary Database suggest that the average remuneration of the CEO of a company ranked 146–166 by market capitalisation (equivalent to a market capitalisation of $530–$750 million) was approximately $870 000, compared to the $940 000 in the data provided by CGI Glass Lewis and Guerdon Associates.

Figure 3.15 **CEO total remuneration at similar-sized companies**

Remuneration of CEOs of companies valued at US$500 million, 2006



Source: CGI Glass Lewis and Guerdon Associates (sub. 80, p. 51).

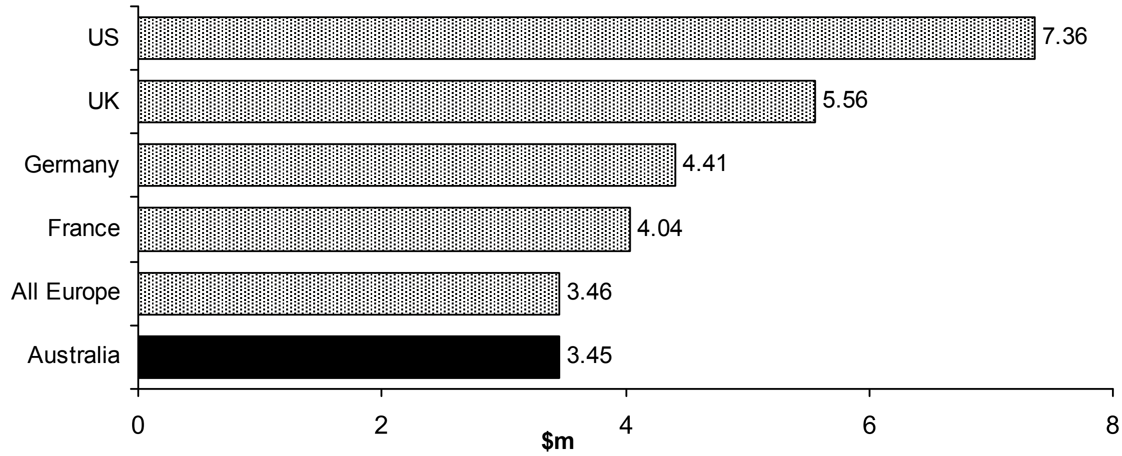
The Hay Group provided the Commission with data on the remuneration of CEOs performing similar-sized roles, based on its job evaluation methodology. The overseas CEOs were employed by organisations with a market capitalisation of approximately $5–$17 billion. They were compared to CEOs of Australian companies in the top 50 (but not in the top 10) by market capitalisation (market capitalisation in this group was between $4.5 billion and $30 billion).

Australian company CEOs' remuneration was less than half that of CEOs in the United States, and significantly less than CEOs in major European countries. Australian CEO remuneration was similar to the average remuneration of all European CEOs performing a similar role (figure 3.16).

Exchange rates and non-financial benefits

Comparisons of remuneration across countries can be significantly influenced by exchange rate fluctuations. Furthermore, exchange rates themselves do not necessarily reflect the differential purchasing power of remuneration packages, resulting from differences in tax and the cost of living. There are also non-financial factors to consider. For example, Australian executives might be prepared to accept lower remuneration to work in Australia because they place a greater value on the quality of life in their home country, including proximity to family and friends.

Figure 3.16 **International CEO remuneration for similar roles, 2008**[a, b]



[a] Data refer to the base salary, bonus and long-term incentives paid to CEOs performing roles of similar levels, as assessed according to the Hay Group job evaluation method. The data do not include the value of 'benefits' (such as health insurance). The Hay Group has advised the Commission that overseas executive remuneration packages often include a far greater weighting towards 'benefits' than in Australia. The reference group is Australian CEOs in the top 50 companies by market capitalisation, but outside the top 10, compared to overseas CEOs of companies with a market capitalisation of between $5 billion and $17 billion. [b] The 'All Europe' category includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland and the United Kingdom.

Source: Hay Group (2009).

Australia compared to the United States

Executive remuneration in the United States is much higher than remuneration in any other country, including Australia. For example:

- The highest-paid CEO in the United States in 2008 was Lawrence Ellison, from Oracle, whose total remuneration (including the value realised from exercising stock options) was estimated at US$557 million (approximately A$653 million) (DeCarlo and Zajac 2009).
- Five other CEOs received remuneration that was estimated to be equivalent to over $A100 million. (In these cases the majority of total estimated remuneration consisted of gains from the exercise of stock options).
- The average remuneration of CEOs of the 500 largest companies in the United States was estimated to be US$11.4 million (approximately A$13.4 million).

By way of comparison, the reported remuneration of the highest paid Australian CEO in 2008 was estimated at $29 million and the remuneration of CEOs in the ASX300 averaged approximately $2.9 million. Only eight Australian CEOs earned more than the *average* remuneration of a top 500 CEO in the United States (this number includes Rupert Murdoch, the American-based CEO of News Corporation). However, it should be noted that the estimated remuneration of Australian executives does not include the estimated value of stock options exercised.

As noted, like-for-like comparisons between remuneration in Australia and the United States is complicated by differences in company size and industry sector. The Commission accordingly undertook comparisons for selected Australian companies and similar-sized US companies operating in the same sector (table 3.8). The results suggest that:

- for companies of similar market capitalisation operating in the same sector, CEO remuneration is much greater in the United States than in Australia
- the differences in remuneration are smaller in the finance sector.

Table 3.8 **Comparing CEO remuneration in Australia and the United States, 2007-08[a]**

	Units	*Australia*	*United States*
Company		Rio Tinto	Freeport McMoran
Market capitalisation	$b	55.5	32.6
CEO total remuneration	$m	13.1	43.1
Company		Alumina	Titanium Metals Corporation
Market capitalisation	$b	2.0	1.4
CEO total remuneration	$m	1.6	1.2
Company		Woolworths	Safeway Stores
Market capitalisation	$b	29.6	9.6
CEO total remuneration	$m	6.9	13.1
Company		Harvey Norman Holdings	Whirlpool Corporation
Market capitalisation	$b	3.3	5.4
CEO total remuneration	$m	1.4	6.8
Company		Commonwealth Bank	US Bancorp
Market capitalisation	$b	52.9	47.3
CEO total remuneration	$m	8.7	7.5
Company		National Australia Bank	Bank of New York Mellon
Market capitalisation	$b	40.6	40.3
CEO total remuneration	$m	8.8	13.3

[a] All figures are in 2008 Australian dollars.

Sources: Associated Press (2009); DeCarlo and Zajac (2009); Financial Review Executive Salary Database; FinAnalysis.

4 Drivers of executive remuneration

Key points

- In principle, as for other labour, companies will be prepared to pay up to the value of an executive's perceived potential contribution. By the same token, executives will want a remuneration outcome that is at least equivalent to what they can earn elsewhere, or enjoy in other pursuits.
- But information asymmetries loom large in the market for executive services, because of the 'principal–agent' dichotomy arising from separation of company ownership and control.
  - Incentive pay can promote appropriate executive effort and decision-making, but increased pay risk will inevitably require payment of a premium.
  - The efficiency of executive pay outcomes will be influenced by the efficacy of corporate governance arrangements and the capacities of boards, and by shareholder influence.
- There is no single explanation of the rapid growth in executive pay in Australia.
  - Greatly increased scale of many Australian companies, accompanied by heightened competition for the best executives, appears to explain around one-third of observed changes.
  - Increased globalisation has also led to executive remuneration being influenced by overseas trends, including the 'importation' of incentive pay structures from the United States in the 1990s. Increased use of incentive pay has been a major contributor to pay growth.
  - Board weakness is likely to have been a factor in instances of apparent 'rewards for failure', while complex pay structures are likely to have yielded higher payments than anticipated in some cases.
- Enhanced disclosure will have accelerated the adjustment of pay relativities. It will also have encouraged many companies to position themselves above the 'median', leading to increased average pay.
  - But disclosure does not appear to have led to permanently higher rates of pay growth.
- Improved governance arrangements and enhanced remuneration reporting and shareholder oversight, are providing some protection against executives being able to unduly influence their own remuneration. But not all companies meet best practice so it is difficult to be categorical that senior executives have not, or could not, engage in 'rent skimming'.

Analysis presented in chapter 3 shows that growth in chief executive officer (CEO) remuneration was faster on average in the 1990s than the 2000s. Moreover, recent increases in CEO pay (until 2007) came almost entirely from incentive pay rather than base salary. Furthermore, the reduction in average total remuneration across the ASX300 companies in 2008 and 2009 was driven by reductions in incentive pay.

This chapter examines the forces potentially underlying these observed trends. Establishing why executive pay has increased is important to any assessment of whether intervention is warranted and the most appropriate response. The first section considers the 'market' for executives, to identify the range of possible factors that can influence remuneration outcomes and the efficiency of those outcomes. The remainder of the chapter analyses changes in these factors and interactions among them that might explain the trends reported in chapter 3.

4.1 The 'market' for executives

In some fundamental ways, the market for executives is similar to other labour markets. In principle, employers will be prepared to pay up to the value of a worker's contribution, while employees will want remuneration (pecuniary and non-pecuniary) that is equal to at least what they can earn elsewhere, or can enjoy in other pursuits. However, the eventual outcome will also be influenced by information available to each party (for instance, about the quality of the person or the nature of the work), and any other sources of 'negotiating' power. Such information 'asymmetries' are particularly important in the market for executives, because of the principal–agent dichotomy that arises from separation of ownership and control of public companies discussed in chapter 2. There are two main implications for setting remuneration.

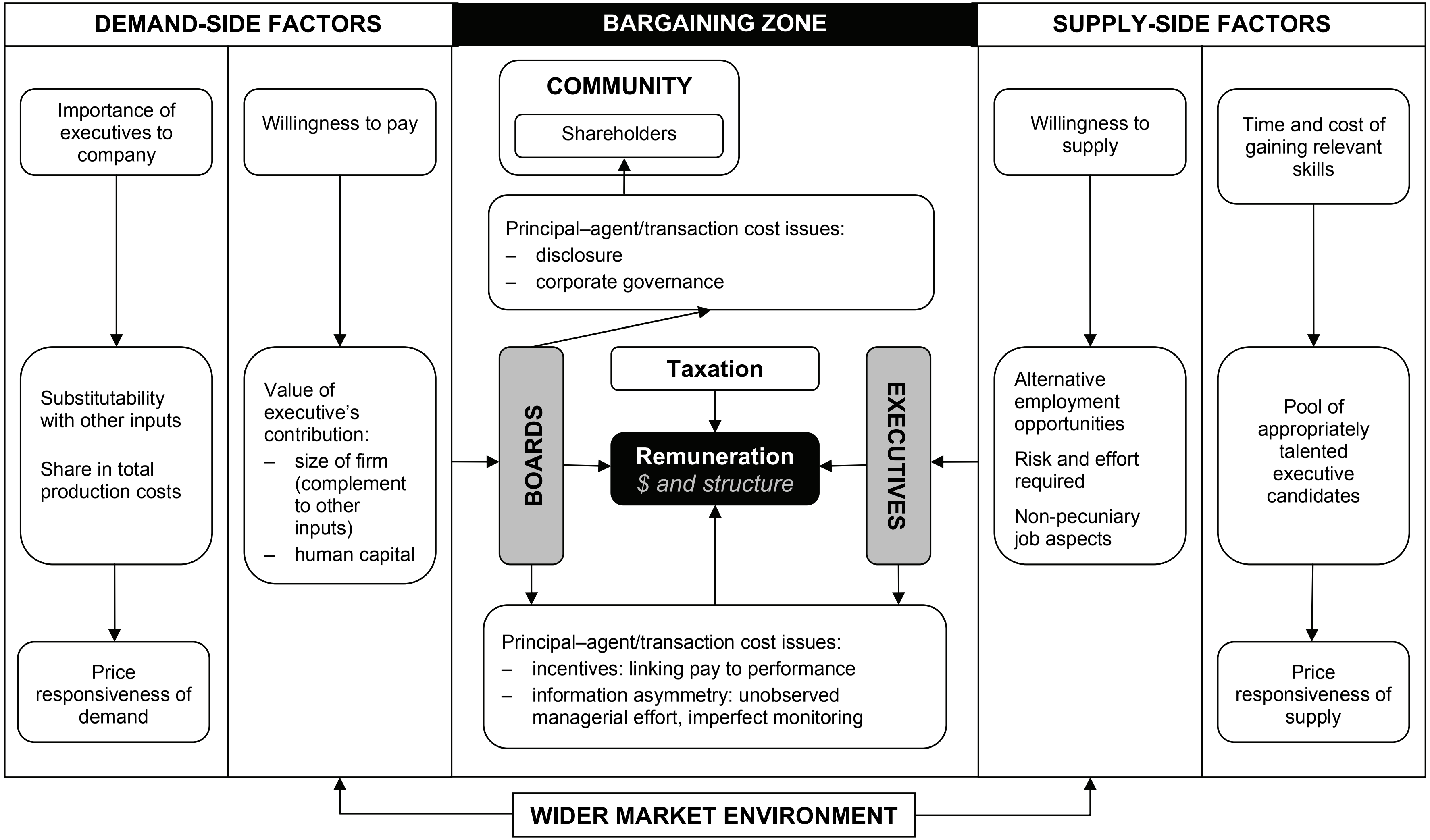
- First, a chief executive performs a distinct and powerful role, with their actions having pervasive effect throughout the company they run. Although executives generally would not wish to harm their reputations by acting in a way that damages their company, their personal goals and perspectives need not always translate into decisions and actions that align with the interests of the company and ultimately shareholders. As *direct* monitoring by the board of the level and quality of executive effort is often difficult and costly, the *structure* of pay can act as an important mechanism for promoting and guiding appropriate executive effort and decision-making.
- Second, a chief executive answers only to the board that hires, rewards and occasionally fires him or her. Consequently, the nature of the relationship, including the balance of power between boards and executives, plays a crucial

role in the negotiation of pay levels and structures and in determining how effective they are in aligning executive actions with company interests in practice. In turn, the degree of alignment between the board's actions and the interests of the shareholder body it represents is crucial for the efficiency of executive remuneration outcomes.

Figure 4.1 depicts the various elements that could have some bearing on observed changes in executive pay outcomes.

- In the panel on the *right* are factors influencing the supply of executive services and the supply 'price' — that is, the minimum, certain, after-tax amount that an executive will require. That minimum will be influenced by: the costs of accumulating the skills, education and experience required for an executive job; potential remuneration in alternative positions (in listed companies or other organisations in Australia or overseas); and the nature of the job, including the risks involved and the effort it demands, as well as any non-pecuniary benefits.
  - The sensitivity of supply to price is a function of the supply of suitable executives. In one sense, the potential supply pool is large as there are many people with managerial experience and qualifications. However, executive quality is likely to vary significantly, with a limited number of executives perceived to have the range of key elements — including judgment, leadership and communication skills — to a sufficiently high degree.
- Demand factors, which influence how much a company is prepared to pay, are summarised in the *left* panel. Broadly speaking, the value of an executive to a company is a function of the task (that is, the contribution of the role to company profitability) combined with the skills and capability brought to it by the individual concerned.
  - The price responsiveness of demand will likely be limited, principally because executive functions can only be performed by executives with appropriate characteristics. Although pay for the CEO is unlikely to form a major component of the firm's total costs, it can have some bearing on pay setting for other company executives and possibly for other employees, which would make companies more sensitive to pay quantum.
- The peculiar 'double-barrelled' principal–agent relationship between executives and boards, on the one side, and between boards and shareholders on the other, is captured in the *middle* panel. Factors influencing this relationship and pay outcomes include: information asymmetries and transaction costs that can lead to potential misalignment between executive actions and decisions and the interests of the company and shareholders; and the efficacy of governance arrangements in place to address conflicts of interest, including scope for executives to set their own pay.

Figure 4.1 **Many factors can affect remuneration outcomes**



- Taxation and the broader market and social environment could also influence remuneration design and outcomes, and are included in the middle panel. In particular, the nature of regulatory and market conditions will likely affect the incentives facing all parties. For example, where companies operate in protected markets, executives and boards may be able to take a greater share of profits or pursue a quieter life, with shareholders still able to enjoy high returns (at the expense of consumers). In competitive trade-exposed industries where company performance will be more closely related to executive performance, executives will have a greater need to perform well in order to preserve their position and reputation, and shareholders will have greater incentives to monitor executives. Thus, competition in product and capital markets will place pressure on executives to perform in the company's interests, complementing incentive pay and governance arrangements.

It follows that increases in executive remuneration could result from increases in the supply price or demand for executives, a change in the relationship between boards and executives or, indeed, interactions among any number of such factors. Some factors are potentially of greater potential policy interest than others — essentially those impeding efficient outcomes. As discussed in box 4.1, efficiency requires that all potentially valuable transactions (in the sense that they generate net benefits for both parties) take place, so that total community 'surplus' is maximised.

In the context of the market for executives, efficiency would require that firms hired the most suitable executive for them, paying up to the value of the contribution of the particular executive in that position (including any 'spillover' effects on other employees' productivity). But because each executive will have different abilities, there will not be a single market 'price' — just as there is no single price for differentiated goods and services. Therefore, in a reasonably well-functioning market, differences in executive pay ultimately would reflect different levels of talent and ability in broadly similar jobs, as well as the different nature of jobs. Furthermore, it would be expected that the returns to 'talent' would largely be appropriated by the owners — that is, the executives. In this way, the price mechanism ensures that the most highly-talented executives are allocated to their most highly-valued uses.

Box 4.1 **Executive remuneration and economic efficiency: some theory**

Economic efficiency requires that all potentially valuable transactions take place. In the context of the market for executive services, efficiency means first, hiring the executive with the greatest potential to enhance company profits over time (accounting for the social costs of production) and second, making sure he or she does so.

- To attract the 'right' person, companies may have to pay a premium to match what other potential employers are prepared to pay. This will ensure executives are employed by companies that place the highest value on their services. To that extent, the higher remuneration represents a transfer of producer surplus rather than an efficiency loss. Indeed, without the ability to bid up remuneration to reflect the premium placed on particular characteristics, there could be an efficiency loss from misallocation to lower-valued employment. (Of course, if there were an unlimited supply of identical, equally highly-talented and able executives, there would be no 'scarcity' premiums.)
- As in any market, outcomes will be affected by various 'transaction costs', including the costs of obtaining information and monitoring performance. While transaction costs are real costs and any reduction in them represents an efficiency gain, the costs of reducing them must also be accounted for.
- Information asymmetry pervades the relationship between executives and boards and, taken to the extreme, could only be eliminated by not separating ownership and control and relinquishing the benefits of specialist managers. More realistically, efficiency can be promoted by implementing measures designed to ensure that executives' actions promote profit maximisation over time (such as incentive pay structures, monitoring and governance arrangements), to the point that the incremental benefits they provide equal the costs. Put another way, the potential gains forgone because it is too costly (or simply infeasible) to monitor executives to the *nth* degree, or to design 'optimal' remuneration packages, do not represent a net efficiency loss because they can only be realised by incurring even greater costs.
- The cost–benefit tradeoff and hence the case for action, will be affected by the magnitude of the potential impacts of executive actions. For example:
  - CEOs of large companies have the potential to generate large absolute gains and losses in company and shareholder value, and thus the payoff from efforts by boards to align executive performance with owner interests will be greater
  - performance of some firms might have broader sectoral or community 'spillover' impacts (for example, a loss of confidence in the financial sector) which should be taken into account in assessing whether action on executive pay is warranted
  - even 'overpayments' that involved a relatively small transfer of profits from the company's shareholders to executives, might be interpreted as board 'failure' and, if occurring in a number of companies, undermine investor confidence in corporate governance, with ramifications for equity markets.

Consequently, if remuneration increases were driven by increases in value generated by executives, or increased competition for the most highly-talented candidates, this could be seen as the outcome of a reasonably well-functioning market. Nevertheless, shifts in demand and supply could be driven by inefficient or undesirable external ‘shocks’, such as strong pay growth in the United States. If remuneration increases were underpinned by a diminution in board independence or accountability, this might indicate a poorly functioning market, with adverse efficiency implications — particularly if such remuneration increases were linked to actions that harmed company performance or undermined investor confidence (box 4.1).

4.2 Explaining increases in executive remuneration

A number of hypotheses seeking to explain why executive remuneration has grown in recent decades have been advanced by researchers and practitioners, as well as by participants to this inquiry. Some emphasise the role of imperfections in corporate governance that allow successful rent-seeking to occur. This view, with Bebchuk and Fried its main proponents, is popularly referred to as managerial power theory (box 4.2).

However, the managerial power hypothesis has been challenged by others who consider that market forces have increased both the willingness of companies to pay for executives and the opportunity cost of potential executives, and that these are the primary reasons for the growth in executive remuneration (box 4.3).

Although these perspectives might seem diametrically opposed, they are not mutually exclusive, as Bebchuk and Fried themselves have noted:

> Although the managerial power approach is conceptually quite different from the optimal contracting approach [whereby company boards design remuneration packages to maximise shareholder welfare], we do not propose the former as a complete replacement for the latter. Compensation arrangements are likely to be shaped both by market forces that push toward value-maximising outcomes, and by managerial influence, which leads to departures from these outcomes in directions favourable to managers. (2003, pp. 72–3)

In other words, both efficient market influences as well as some degree of failure by boards to set executive pay efficiently, could co-exist.

Box 4.2 **Bebchuk and Fried's 'managerial power' hypothesis**

According to US academics, Bebchuk and Fried (2003, 2004), US executives have the ability to obtain remuneration arrangements that are more favourable than those that would arise from 'arm's length' bargaining processes, due to their influence over 'captive' company boards. Not only is there a principal–agent problem between company owners and managers, there is also an agency problem between shareholders and the boards they elect to represent them.

The ability of executives to obtain higher remuneration, however, is limited by so-called 'outrage' costs and constraints; that is, negative reaction by shareholders, the business media and others, which can lead to reputational embarrassment for executives and company directors.

To extract higher pay, executives (and compliant boards) therefore will seek to 'camouflage' their remuneration arrangements to limit external scrutiny. Bebchuk and Fried contend that US executive pay rose significantly from the 1990s because:

- executives used their influence to obtain significant amounts of option pay without forgoing corresponding amounts of cash remuneration
- options were not tightly linked to the performance of executives, allowing them to 'reap windfalls' from movements in share prices that were due to market and industry trends beyond their control ('pay for good luck')
- the rising sharemarket of the 1990s provided a 'convenient justification' for increases in remuneration at many companies (even relatively poorly performing ones) due to the long-established correlation between remuneration and company size
- 'outrage costs' and constraints were also weakened in the market boom, with shareholders less likely to scrutinise generous remuneration arrangements
- termination and other deferred pay and company loans could be 'hidden'.

The following examination of potential explanations for pay increases of Australian executives explores all the possible channels set out in figure 4.1, beginning with factors influencing the efficiency of arrangements negotiated between boards and executives, before considering demand and supply drivers.

Box 4.3 **'Market–based' explanations of pay rises**

Alternative explanations for the observed rises in executive remuneration include: growth in company size (Gabaix and Landier 2008), increasing importance of general managerial, as opposed to company-specific, skills (Frydman 2005; Murphy and Zabojnik 2004, 2006), higher incentive pay and risk aversion requiring increases in overall remuneration (Gayle and Miller 2008), and talent and risk (Sung and Swan 2009).

Other aspects of remuneration arrangements that Bebchuk and Fried (2003, 2004) argue indicate 'rent' skimming, may actually be efficient, according to some researchers:

- Apparent insensitivity of pay to performance: Haubrich (1994) demonstrated that, if executives are sufficiently risk averse, low pay-performance sensitivities may be optimal, while Edmans and Gabaix (2009) argue that even a small equity stake is sufficient to deter shirking in large companies due to the large effect of CEO effort in large companies.
- Sensitivity of pay to luck: Gopalan, Milbourn and Song (2008) show that the absence of payment for luck can make company investment decisions insensitive to industry performance, which is suboptimal if company performance depends on industry performance. Noe and Rebello (2008) postulate that past company performance, even if unrelated to CEO effort, provides information about the company's ability to generate future cash flows, raising the CEO's contribution to the company, and hence, remuneration.

4.3 'Principal–agent' issues and executive pay

As shown in chapter 3, increases in Australian CEO pay over the 2000s came almost entirely from short- and long-term incentive pay rather than base salary. This was particularly the case for the largest companies.

At issue is whether observed trends resulted from board efforts to promote incentive alignment and hence company performance, or were symptomatic of poor corporate governance and weak 'outrage' constraints. Governance arrangements for Australian public companies are explored in greater detail in part C of this report. The following sections briefly examine the evidence of any links between apparent gaps in governance and limited board capacities, and movements in executive pay.

Board independence

Weak or compromised boards might be expected to 'give in' to executive demands for higher pay compared with competent, independent boards. Measurable indicators of board independence include whether the CEO chairs the board, the representation of independent directors and the size of the board.

Having a dual CEO/chair (particularly for so-called 'widely-held' companies with diverse ownership) has the potential to concentrate a significant degree of power on the CEO, and lead to less effective monitoring of the actions of executives. Indeed, the ASX Corporate Governance Council, in its principles and recommendations on corporate governance specifies (recommendation 2.3) that 'the roles of chair and chief executive officer should not be exercised by the same individual' (2007a, p. 10).

Board size also is used as an indicator of the effectiveness of board monitoring. Some, such as Jensen (1993), have argued that the larger the board, the lower the likelihood of individual members being held accountable for their decisions, also making it easier for CEOs to exert influence. Recent analysis of pay differences between the United States and the rest of the world suggests that larger US boards explain a small part of the gap (Fernandes et al. 2009). Table 4.1 illustrates some of the differences in the characteristics of US and Australian boards according to various studies. Generally, Australian boards are smaller than US boards and have a much lower incidence of CEO/chair duality (particularly for larger companies).

Table 4.1 **Characteristics of US and Australian boards**

Study	*Nation*	*Period*	*Companies covered by study*	*Incidence of CEO/chair duality*	*Average board size*
			no.	%	no.
Lau, Sinnadurai and Wright (2009)	Australia	1997–2004	108	5	8.5
Cornett et al. (2008)	United States	1994–2003	S&P100 companies	na	12.8
Fahlenbrach (2009)	United States	1993–2004	2 071	68	9.8
Kiel and Nicholson (2003)	Australia	1996	348	23	6.6
Linck, Netter and Yang (2008)	United States	1990–2004	6 931	58	7.5

na Not available.

Sources: Cornett et al. (2008); Fahlenbrach (2009); Kiel and Nicholson (2003); Lau, Sinnadurai and Wright (2009); Linck, Netter and Yang (2008).

More recent data from the Australian Council of Super Investors (ACSI 2009c) show that, in 2008, for a sample of 87 ASX100 companies, average board size for an Australian company was 8.8 (in contrast to the previous year's 8.5). The positions of CEO/chair were combined in only two of the companies in the sample studied.

In addition, in 2007-08, for the top 300 Australian companies, three-quarters of directors were non-executive directors, increasing to 80 per cent for the top 50 companies (Korn/Ferry International and Egan Associates 2008). The average proportion of *independent* directors was a little over half for boards of the top 300 companies, with larger companies having a higher proportion of independent directors (Guerdon Associates 2009b).

While these indicators provide some *prima facie* evidence that Australian boards (especially of larger companies) are notionally independent — and more so than their US counterparts — they do not prove that 'rent skimming' has not occurred. In practice, some nominally independent directors may still be dominated by the CEO.

Have Australian boards been captured by CEOs?

Indicators of how independently boards operate in practice include the extent to which they hire externally and how they remunerate external appointees relative to internal hires, their propensity to fire CEOs, and the independence of their decisions on remuneration setting.

External versus internal hires and relative pay

If CEOs and senior executives exercise undue power over the board of directors, it might be expected that most CEOs would be recruited internally and, moreover, that internally-promoted CEOs would earn more than those recruited externally (Murphy and Zabojnik 2004). The reason is that internal applicants are likely to have established relationships with the board and already be accustomed to extracting 'rents'.

The Australian Council of Super Investors (ACSI) commissioned a study by RiskMetrics analysing executive hires and departures at the 50 largest ASX companies between 2003 and 2007 (ACSI 2009b). A comparison of the fixed pay of newly-hired CEOs with that of the outgoing CEO indicated that 16 of 28 (nearly 60 per cent) newly-hired CEOs were promoted internally, while 10 (around one-third) were hired externally (the others were accounted for by firm acquisition). Of the 10 externally-hired CEOs, five were paid more fixed pay than their predecessor, two received the same fixed pay, and three received less fixed pay. The median increase in pay for external hires was a little over 4 per cent. Conversely, pay for internal hires was generally less than for their predecessor — the median decrease in fixed pay was around 12 per cent. The study also notes that the remuneration received by externally-appointed CEOs could be under-estimated, because ‘sign-on’ payments to compensate for accrued benefits forgone at their previous company are common.

How real is the threat of being fired?

Weak or ‘captured’ boards generally would not be expected to fire their CEO. A recent study by Manning and Mottram (2009) reveals that between 2000 and 2008, an average of eight CEOs in ASX200 companies were fired each year (see figure 4.2). According to ACSI (2009b), terminations accounted for more than one-third of all executive departures over the period 2003–07 (82 out of 230), using a sample of 50 of the largest ASX-listed companies. While providing evidence that termination is a real threat for some executives, the extent to which this threat extends to other companies listed on the ASX is unclear.

Independence of remuneration decision making

Because some executives invariably sit on company boards, conflicts of interest can arise when boards set executive pay. Boards can employ various procedures to reduce such conflicts, including establishing remuneration committees and seeking external advice on market comparators to frame their offer.

As outlined in chapter 6, most large Australian companies have established remuneration committees (almost all of the top 50 companies); around three quarters of remuneration committees in larger firms have only non-executive directors as members, and a majority of the remuneration committees of the top 400 companies comprise a majority of *independent* non-executive directors and have an independent chair. The flipside is that a significant minority of remuneration committees still comprise executive directors (CGI Glass Lewis and Guerdon Associates, sub. 80; WHK Horwath 2009a, 2009b).

While it is known that boards typically seek and receive advice from remuneration consultants, apart from anecdotal evidence, there are few data about the procedures followed to avoid conflict of interest where a consultant also advises management on remuneration or other matters.

It could also be the case that because many non-executive directors are former executives, the distinction between current executives and directors in practice is blurred. In essence, they could be regarded as members of the same club or ‘culture’. As discussed in chapter 6, there are issues about the diversity of board composition and the contestability of appointments. But it is impossible to conclude that former executives are more likely to be sympathetic to executive pay demands than other directors. Indeed, it is conceivable that former executives are more astute in pay bargaining matters than directors who lack first-hand experience (and they may be more resistant to remuneration levels greatly exceeding what they earned in the same role).

Transparency

Remuneration disclosure requirements in Australia have been progressively strengthened over the past 25 years, as illustrated by box 2.5. Prior to 1986, listed companies were only required to disclose the total level of collective remuneration paid to all executives earning more than $100 000 during the year. Current disclosure requirements require listed companies to disclose the remuneration packages of all company directors, key management personnel and the five highest-paid executives (including details on the structure of payments, such as cash, short-term incentives, and the like). Increased disclosure might be expected to have reduced the extent to which executives could camouflage remuneration and strengthened 'outrage' constraints, although there remain issues about the quality of remuneration reports and the extent of disclosure about performance hurdles (chapter 8).

A related reform was the introduction of the non-binding shareholder vote on company remuneration reports in 2004-05. The vote has allowed shareholders to voice their (dis)approval of a company's remuneration report in its entirety, giving shareholders an additional avenue for expressing 'outrage'. As set out in chapter 9, while very few remuneration reports have attracted a majority 'no' vote, 12 per cent received a 'no' vote above 20 per cent in 2008, compared with 3 per cent in 2006 (PricewaterhouseCoopers, sub. 85).

The United States does not have a vote on executive remuneration, leading Bebchuk to observe:

> Introducing advisory votes on compensation at the annual meeting, as the UK and Australia did, would help shareholders influence pay arrangements and would move pay arrangements toward those that best serve shareholder interests. (2007, p. 4)

But the benefits of enhanced disclosure and the advisory shareholder vote to shareholder scrutiny might have been offset to some degree by complacency among shareholders about returns and company performance during the sharemarket boom over the 2000s. Shareholders could have become relaxed about executives receiving higher pay because of strong profits, even though profits might have reflected factors outside the executive's control. While such 'profit-sharing' might have been a considered choice by shareholders, it could nonetheless have contributed to higher pay outcomes.

Remuneration disclosure and ratcheting pay

While disclosure of executive pay generally is seen as increasing board accountability and thus potentially constraining executive pay, many participants argued that enhanced disclosure had been a significant contributor to pay increases. For instance, Mercer submitted:

> Disclosure requirements are also seen as adding to the ratcheting-up effect of CEO remuneration. Directors take for granted that CEOs compare their own pay relative to peers, thus providing a further avenue for CEOs to establish their respective expectations and negotiating stances. Similarly, remuneration committee members use the data to benchmark their chief executives and make their own assessments of appropriate external relativities. (sub. 41, p. 5)

Similarly, Chartered Secretaries Australia stated:

> It can be argued that disclosure has led to upward pressure on remuneration. Boards benchmark the remuneration of executives with the remuneration of executives of companies in a peer group, as this information is publicly available. Combined with the practice of aiming to reward executives at the median or upper quartile of such peer group, an autonomous upward pressure ('ratchet effect') on the remuneration of executives of all companies is created … (sub. 57, p. 16)

But some others countered that pay arrangements had always been known among executives and boards, with public disclosure introduced in 1998 bringing little new information to the negotiating table. For instance, ACSI stated:

> Some commentators have also suggested that improved levels of remuneration disclosure may have also contributed to the ratcheting up of executive remuneration. It is however, ACSI's long held view that executives and boards have always had access to remuneration data from remuneration consultants with the only change being that shareholders now have access to similar information. (sub. 71, p. 2)

It can be plausibly argued, nevertheless, that the *public* disclosure of an individual's remuneration brings an additional 'signalling' role. Referred to as the 'Lake Wobegon' effect,[1] public disclosure might have triggered a pay adjustment spiral as companies and executives sought to 'position' themselves in, say, the third quartile of the market, with no one wishing to be seen as hiring, or being, a 'below average' executive.

[1] Lake Wobegon is the fictional hometown of US humorist Garrison Keillor, a place in the mid-West where 'all the women are strong, all the men are good looking and all the children are above average'.

For instance, based on a game theoretical model, Schaefer and Hayes (2008) suggest that if executive pay is viewed by investors as an indicator of executive quality, companies might increase remuneration in order to enhance market perceptions of talent and company prospects (box 4.3 and appendix D).

It also has been postulated (by, for example, Camerer and Malmendier 2007) that if executives are paid less than peers they regard as undeserving, pay ratcheting could be unleashed by disclosure — a so-called 'positional' externality effect. However, such demands are less likely to be met when board governance and the 'outrage' constraint are stronger — and enhanced disclosure simultaneously strengthened the latter.

For Australia, there is little empirical evidence of an acceleration in the growth of executive remuneration following introduction of the new disclosure rules in 1998. Indeed, pay growth slowed somewhat in the 2000s compared to the late 1990s (although there may have been other forces at work). The observed decline in executive remuneration since 2007 provides further evidence that not all companies are locked into providing above average remuneration regardless of market circumstances.

That said, detailed knowledge of pay arrangements for individuals will certainly have improved access to market comparator information for both executives and boards, which in some cases could have strengthened the executive's bargaining position (particularly as disclosure could facilitate 'poaching') and, in other cases, that of the board (armed with knowledge of the market norm).

Enhanced disclosure would also be expected to have facilitated more rapid adjustment where 'equilibrium' relativities were disturbed (for example, by a firm hiring an overseas executive at a significantly higher level of remuneration).

Pay disclosure and tournaments

The Lake Wobegon effect specifically considers the pay differentials between executives of different companies, and what effect this has on equilibrium remuneration in the market for executives. Pay differentials also obviously exist *within* companies, and the 'tournament theory' of corporate advancement (Lazear and Rosen 1981) provides an explanation as to why large pay differentials might exist between individuals working in distinct hierarchical positions within a company. It is conceivable that changes in inter-company differentials might have contributed to the observed increase in executive remuneration, which, in the context of this theory, would mean that an internal 'ratcheting' mechanism of sorts is present.

The tournament theory suggests that high remuneration for senior company officers does not necessarily reflect their current productivity, but instead provides an incentive to those in more junior positions to increase their current productivity. The objective of this payment structure is to make individuals more productive over their working lives by inducing them to work harder now in order to receive a promotion (and increase in pay) in the future, and provide the appropriate incentives to acquire the necessary skills before being appointed to a senior position. In essence, pay differentials within the company are 'prizes' that accrue to individuals who are the winners of contests based on performance for more senior positions within the company. As noted by Lazear (1989) however, the larger the spread between the remuneration received by the winners and losers of contests, the greater the possibility that such a pay structure can encourage uncooperative behaviour and lead to disharmony. If cooperation and harmony are important to the company, some degree of pay compression may be optimal on efficiency grounds.

Although the tournament theory may in part explain why there can be large observed differences between the remuneration of individuals within a company, it provides a less compelling explanation of why the level of executive remuneration, or the size of the prize, has continued to increase (in real terms) over time. That is, what would have changed about the nature of tournaments to make larger prizes to the winners necessary?

In other words, rather than accounting for the dynamics of movements in executive remuneration, tournament theory instead could at best explain, at least to some extent, the static structure of pay arrangements within companies.

The role of incentive pay in driving remuneration increases

From the late 1980s, the composition of executive remuneration in Australia has changed fundamentally, with a much greater focus now being placed by boards on equity-based remuneration, such as options and ordinary company shares, and other incentive-based forms of remuneration. As observed by Egan Associates:

> Executive performance awards in the 60s and 70s through to the early 80s reflected more of a modest profit share than the outcome of a multi-factor formal incentive program. Progressively from the mid 80s there was an increasing emphasis on profitability and growth in a company's market value. (sub. 105, p. 17)

Incentive-based pay has the potential to reduce the 'agency' costs that might arise if executives were paid fixed cash amounts only. At the heart of the principal–agent problem is the reality that executives might naturally be inclined to exert less effort or, perhaps more realistically, focus on growth and acquisition strategies that fit their risk preferences, rather than strategies that would maximise company profitability over time. Consequently, in principle, companies will be willing to implement incentive-based forms of remuneration if they can (at least) offset the extra outlays either by influencing executives appropriately or by reducing the costs of monitoring executives. (If direct monitoring of executives by boards is relatively inexpensive, incentive pay will not be an efficient alignment strategy.) Of course, whether incentive pay arrangements are successful will depend on the quality of their implementation in practice. Successful implementation will depend on the quality of their design by the board, which in turn will be influenced by the capacities and experience of directors.

Incentive pay goes with higher 'expected' remuneration

While incentive pay can promote alignment of managerial and shareholder interests, it:

- typically introduces additional variability and hence uncertainty about the *level* of remuneration executives will eventually receive (for example, because performance hurdles are susceptible to the influence of forces outside their control or because of the uncertain value of equity-based remuneration)
- can constrain executives' ability to diversify their wealth, thus exposing them to portfolio *risk*
- usually involves *deferment* of pay (and thus losses from delaying the benefits of consumption).

As executives typically are 'risk averse' with respect to their own income (see, for example, Hall and Murphy 2002), they will want to ensure that the incentive pay offered (in current dollars) at least compensates them for the additional earnings risk involved. (Of course in practice, this will be a somewhat intuitive calculation, requiring judgment about the riskiness of various scenarios.)

Hence, introducing uncertainty into an executive's remuneration structure generally will mean that the level of remuneration offered must increase *compared to certain, cash pay*, because of the payment of a risk premium. If boards are acting appropriately, they will be prepared to offer a premium only up to the point where it elicits an improvement in executive (and company) performance (or a saving in monitoring cost) of commensurate value.

Portfolio risk

Executives not only have their human capital (and reputation) heavily invested in the company they manage, they also typically have a significant amount of their personal wealth (shares and options) tied to its performance. Indeed, this is a major objective of equity-based incentive remuneration. However, remuneration via equity, and requirements to hold equity in the company for which they work, can be risky for executives. As an illustration, table 4.2 shows the holdings and computed values of ordinary company shares by ANZ executives over a period of several years. It shows that changes in share prices can have significant wealth effects. This is particularly clear with the decline in the ANZ share price in 2007-08.

Table 4.2 **ANZ executive shareholdings[a, b]**

	Quantity				*Value*			
Executive	2005	2006	2007	2008	2005	2006	2007	2008
	no.	no.	no.	no.	$'000	$'000	$'000	$'000
1	421 733	421 733	388 399	381 976	10 122	11 328	11 535	7 162
2	88 638	96 083	332 092	332 092	2 127	2 581	9 863	6 227
3	171 919	239 319	282 054	282 054	4 126	6 428	8 377	5 289
4	641 633	660 513	572 629	574 227	15 399	17 741	17 007	10 767

[a] Quantity held and value at 30 September, or where appropriate, last business day in September. [b] Includes directly and indirectly held shares, and shares held by related parties.

Sources: ANZ annual reports (various); Yahoo! Finance (2009b).

Table 4.3 gives another example, using three executives from Wesfarmers. Even though the Wesfarmers share price fell by nearly $8.50 between 30 June 2007 and 30 June 2008, the value of shareholdings by the three executives considered here rose due to an increase in the quantity of shares held, indicating that the personal wealth of executives is indeed linked to the fortunes of their company.

Table 4.3 **Wesfarmers executive shareholdings[a, b]**

	Quantity				*Value*			
Executive	2005	2006	2007	2008	2005	2006	2007	2008
	no.	no.	no.	no.	$'000	$'000	$'000	$'000
1	106 048	119 256	195 633	302 757	4 243	4 213	8 946	11 293
2	142 908	153 224	191 412	260 669	5 718	5 413	8 753	9 723
3	48 131	57 416	79 837	104 589	1 926	2 027	3 651	3 901

[a] Quantity held and value at 30 June, or where appropriate, last business day in June. [b] Including shares held by related parties.

Sources: Wesfarmers annual reports (various); Yahoo! Finance (2009c).

Meulbroek (2001) analyses the impact of the inability of executives to hold optimally diversified portfolios on their valuation of equity-based forms of remuneration. Her estimates of the value of option payments to executives for New York Stock Exchange listed companies are presented in table 4.4. The less diversified the executive's portfolio, the lower the valuation of the option relative to its cost to the company, reflecting increased exposure to company-specific risk. Similarly, the longer the vesting period, the lower the net present value to the executive of the uncertain payment. This general framework can be applied to all forms of risky pay that restrict the ability of executives to hold a fully diversified investment portfolio.

Table 4.4 **Executive discounting of equity-based remuneration**[a]

Value of options to manager as a ratio of company cost, per cent[b]

	Vesting in 3 years	*Vesting in 5 years*	*Vesting in 10 years*
Completely undiversified	77	66	45
75 per cent undiversified	80	70	51
50 per cent undiversified	84	76	60
25 per cent undiversified	91	85	74

[a] New York Stock Exchange listed companies. [b] Mean values.

Source: Meulbroek (2001).

Hall and Murphy (2002) likewise find that as the degree of executive risk aversion increases, and the more an executive's wealth is held in company shares, the amounts required to compensate executives for forgone certain cash remuneration increase. They also construct 'risk-adjusted' (certainty equivalent) measures of remuneration for CEOs of companies listed on the (US) S&P 500 industrial index in the 1990s. Their results suggest that the growth in the discounted 'certainty' value of remuneration to CEOs during this period was significantly lower than the growth in the reported cost of CEO remuneration to companies.

In a similar vein, Fernandes et al. (2009) suggest that a significant part of the observed gap between reported US executive pay levels and those for the rest of the world (including Australia) is attributable to the 'risk premium' to compensate for the higher proportion of performance-linked pay, especially equity and option-based pay, in that country.

Although these studies relate to the United States, they have general application, including to Australia. As shown in chapter 3, the composition of CEO and other senior executive remuneration has become more heavily weighted towards short- and long-term (mainly equity-based) incentives since 2003-04. Furthermore, since 2003-04, for CEOs of ASX300 companies, all of the increase in executive remuneration that has occurred has been in the form of short- and long-term incentives. It is therefore likely that reported fair values (which estimate the expected cost to the company of equity-based pay) as well as values of cash-based incentive pay, incorporate a risk premium for the uncertainty they create.

More incentive pay for bigger companies?

For larger companies, agency costs can be larger because of more dispersed ownership and the potentially greater influence of executives over company assets (Jensen and Meckling 1976). This means that larger companies might have a greater willingness to issue incentive pay to executives in order to more closely align the interests of managers with those of the company and its shareholders.

Gayle and Miller (2008), with specific reference to the United States, argue that the most important influence on the increase in executive remuneration in the industries they analyse (aerospace, chemicals and electronics) is related to this 'moral hazard cost' of increasing company size (their model explains around half of the variation in remuneration during the sample periods studied). If Gayle and Miller are correct, executives of larger Australian companies would be expected to receive a higher proportion of their remuneration in the form of short- and long-term incentives, rather than base pay.

The evidence in chapter 3, while not demonstrating a perfect relationship, lends some support. For example, figure 3.2 shows that, for CEOs and executives in the ASX20 companies, short- and long-term incentives form a higher proportion of total remuneration than for smaller companies, where base pay is relatively more significant. For CEOs in the largest 20 companies, nearly 60 per cent of the total remuneration package consisted of short- and long-term incentives in 2008-09, while at the lower end of the spectrum, for the companies ranked 151–200 in the sample, short- and long-term incentives accounted for around 40 per cent of the total remuneration package. A similar story holds for senior executives (see appendix B).

Has incentive pay disguised rent-skimming?

While in theory incentive-based pay can be an efficient means of aligning executive performance with shareholder interests, incomplete knowledge and pay complexity could give executives scope to mould performance measures and hurdles in their favour, such that 'at risk' pay becomes a virtual certainty, even rewarding failure. In this case, the premium that firms are prepared to pay for alignment would simply translate to additional pay, not pay for incremental performance. This could occur even if boards were not under a CEO's influence, but just incapable of properly understanding the implications of the arrangements they agree to.

Bebchuk and Fried (2003) contend that the rapid growth in remuneration of US executives largely from options-based incentives supports the notion of board capture by CEOs, because there was no offsetting reduction in cash pay; there were few performance hurdles; and executives could benefit from good luck without facing consequences of bad luck.

A number of participants suggested that the recruitment of US executives to Australian firms in the early 1990s, including notably Bob Joss, Frank Blount and George Trumble, spearheaded the importation of US remuneration levels and structures, in particular, incentive-pay arrangements. As noted by Mercer:

> … these high profile appointments were influential in the subsequent widespread adoption of equity-based incentive remuneration systems by Australian corporations during the 1990s. For example, the median percentage of the long-term incentive component of a benchmark of Australian CEO remuneration packages increased from 6.3 per cent of total remuneration to 32 per cent over the period 1987 to 2000 and the total performance component of pay (i.e. short- and long-term incentives) rose from 9.5 per cent to 47 per cent. (sub. 41, p. 2)

According to Egan Associates, incentive pay had been growing in Australia from the mid 1980s, but its adoption accelerated following the early 1990s recession, with:

> … a progressive emphasis on equity-based, long-term incentives and the meeting of performance hurdles, initially related to share price and then progressively total shareholder returns and earnings per share … (sub. 105, p. 18)

Though influenced by the United States, incentive pay arrangements in Australia have significant differences.

- Options — which have particular incentive properties (box 4.4) — have not been used widely in Australia. ACSI (2009d) estimates that the use of options peaked in 2001-02, accounting for about one-fifth of total CEO pay (for CEOs of the top 100 companies), falling to approximately 11 per cent by 2008 (albeit with some volatility year-on-year). The decline in option pay has been broadly matched by an increase in performance rights, which accounted for around 12 per cent of remuneration by 2008.
- Options have also been more 'visible' in Australia because of an accounting standard requirement to debit their expected costs in the company's financial statements, and the requirement to disclose the individual costs for the CEO and other executives in the remuneration report since 2003-04.
- Compared to the United States, where there is 'higher leverage to at-risk pay … in the form of options, and incentives that are linked to tenure rather than future organisational performance' (Mercer, trans., p. 331), performance hurdles have been more routinely applied to option grants and other equity-based remuneration in Australia. Short-term hurdles often comprise both financial and non-financial metrics such as accounting performance, company strategy

implementation, succession planning and workplace safety. Since the mid 2000s, the most common long-term hurdle appears to be *relative* total shareholder return.

Box 4.4 **Options: rent extraction or efficient incentives?**

The use of options *per se* may not signal rent extraction by executives. The critical test is whether they elicit appropriate performance at least cost to the firm.

In theory, options could form part of an 'optimal' contract. As Edmans and Gabaix observe:

> … owing to their asymmetric payoff structure, options limit the CEO's downside upon bad luck, and this insurance is particularly valuable to a loss averse agent [CEO]. (2009, p. 491)

In other words, providing 'carrots' could be less costly for the company than imposing penalties for poor performance, because in the case of the latter, a risk averse CEO would demand offsetting 'certain' pay that could cost the company more than the carrot.

Options also encourage risk-taking, which might be appropriate for an immature company seeking to grow rapidly, but not for a more mature company where the potential for loss of shareholder value is much greater. They also offer a relatively cheap form of incentive for cash-constrained venture companies. In the latter case, executives are essentially paid tickets in a lottery where the size of the ultimate prize, to some degree, lies within the CEO's control.

But as discussed further in chapter 7, options have the potential to encourage harmful behaviour — for example, for executives to take action to increase the share price in the short term so that options are 'in the money'.

While suggestive, the imposition of hurdles arguably is not sufficient evidence that incentive pay has been appropriately set — for example, hurdles might be ineffectual or inappropriate. Egan Associates noted that by 2005, boards had come to believe that hurdles provided 'an inappropriate lottery effect' (sub. 105, p. 18). Moreover, in the late 1990s 'board discretion or no hurdle at all applied in approximately 30 per cent of organisations' (sub. 105, p. 22).

A number of other criticisms of incentive-pay arrangements have been raised by investors and proxy advisers participating in this inquiry (box 4.5), including that:

- long-term incentives are not sufficiently long term to promote appropriate alignment
- there is too much focus on short-term incentives (often with undisclosed hurdles)
- performance hurdles generally are too 'soft', excessively rewarding mediocre performance and good luck (yet shielding executives' pay from bad luck).

And although (as discussed in chapter 3) there is evidence of a correlation between growth in aggregate executive pay and aggregate corporate performance (including during the recent downturn), this could mask substantial variation across companies.

Box 4.5 **Participants' concerns about incentive pay arrangements**

The Australian Shareholders' Association commented:

> The current unsustainable and unacceptable levels of executive remuneration stem primarily from the following:
>
> - equity incentive schemes which award average, not superior performance
> - rewards for short-term results for executives, particularly CEOs whose primary motivation should be long term
> - an increase in the proportion of remuneration which is said to be at risk (frequently two-thirds) which in fact is placed at very little risk because of poorly structured incentive schemes which pay out even when performance is only average
> - incentive schemes which are said to be long term, which on average measure performance over three years or in some cases less. (sub. 54, p. 7)

While acknowledging the high level of support for remuneration resolutions for the top 200 companies, ACSI observed that remuneration resolutions attracted higher levels of dissent where packages contained:

- short vesting periods for long-term incentives, i.e. less than three years
- insufficiently demanding hurdles without a clear link to long-term performance
- undisclosed hurdles
- increased prevalence of short-term or retention payments in lieu of long-term arrangements e.g. 'de-risking' of pay. (sub. 71, p. 5)

And according to Regnan:

> … there is compelling evidence of short-termism in executive remuneration. (sub. 72, p. 4)

Have executives been 'rewarded for failure'?

As outlined in chapter 1, arguably the strongest motivator for this inquiry is the general perception that executives have been rewarded for failure. This encompasses situations where an executive whose actions have adversely affected the company's profitability or viability, receives bonuses or other rewards, as well as where executive pay, despite an ostensible link to performance, appears unaffected by the general sharemarket downturn.

- The culture of extremely high short-term bonuses in financial market institutions does not appear as pervasive in Australia as overseas; short-term incentives comprised a little over 30 per cent of remuneration for finance sector CEOs in

2008-09 (table 3.5), compared with an average of 25 per cent for CEOs of the top 300 companies. Moreover, as discussed in chapter 7, short-term incentives increasingly are being paid as deferred equity, combining short-term hurdles with medium-term alignment.

- As discussed further in chapter 7, there have been instances where termination payments appear to have exceeded contractual obligations to executives. While payments in excess of obligations might be justifiable (see, for example, Almazan and Suarez (2003) and Heen (2008)), they might also result from a board's aversion to standing up to a departing CEO (or a perceived need for a quiet exit).

A one-way bet?

It is suggested that 'efficient' incentive pay would be associated with a corresponding reduction in fixed pay, and neither reward executives for good luck, nor shield them from bad luck. While incentive pay being added to fixed pay can indicate rent skimming, in principle there are reasons why a fall in base pay need not be observed, including that the additional pay could be designed to encourage incremental performance, and that, in the absence of incentive pay, base pay might have risen (more).

Egan Associates (sub. 105) suggested that incentive pay in Australia initially partly substituted for fringe benefits (after introduction of the Fringe Benefits Tax in 1986) and defined benefit superannuation schemes, neither of which had previously been reported in pay data. This would have led to a significant jump in reported total pay — because of the risk premium incorporated in incentive pay and the shift away from unreported pay forms to a reported one. In the past few years, base pay for CEOs and senior executives of the top 300 companies has fallen slightly in real terms, with its share of total pay falling (table 3.2).

Several participants also observed that executives had benefited from the rising sharemarket in the 2000s, yet their pay had not fallen in line with share price declines in 2008. As the Australian Shareholders' Association stated:

> Incentive schemes such as these [using share prices as a performance metric] have driven growth in executive remuneration based simply on windfall gains from a rising market, rather than actual sustainable long-term performance. If truly at risk, such schemes should not be altered because of the declining market, however it is frequently the case that options are 're-priced' as the share price falls. (sub. 54, pp. 7–8)

It was also argued that if executive pay is related to firm size, a decline in market capitalisation should lead to commensurate reductions.

As discussed in chapter 7, whether or not an executive should be exposed to ‘downside’ remuneration risk will depend on the risk preferences of both the company and the executive. For highly risk-averse executives, in order to achieve desired incentive alignment, it might cost the company less to offer ‘carrots’ only, rather than a mix of carrots and sticks that penalise the executive for the effects of factors outside the executive’s control (that is, bad luck). Moreover, incentive pay is ultimately about providing incentives to perform relative to the (unobservable) counterfactual. In the absence of appropriate incentives, company performance may have been even worse in a difficult economic environment.

Nevertheless, in general, a protracted decline in market capitalisation and company performance should lead to a decline in total executive remuneration, broadly in line with the relationship observed in a rising market. Evidence presented in chapter 3 confirms this, revealing an average annual decline in (real) CEO remuneration across the ASX300 companies between 2007 and 2009 of around 11 per cent, with that for non-CEO executives being 14 per cent (the median decline was around 7 per cent for CEOs and non-CEO executives alike). Furthermore, as illustrated by tables 4.2 and 4.3, remuneration changes can be amplified by wealth changes arising from executives’ shareholdings. As noted by Charles Macek:

> … due to the collapse of the share market executives have lost $billions of income value of equity grants, which have previously vested or have been earned by individual accountabilities. This is not recognised in the reporting of their remuneration … (sub. 55, p. 13)

Did boards simply lose control?

Even with the best intentions, the design of incentive-compatible remuneration is difficult because any ‘solution’ depends on the degree of income-risk aversion of the manager, the risk preferences of company owners, and the assumed likely relationship between managerial effort and observable performance. As explained further in chapter 7, for these reasons there is no single ‘correct’ incentive structure. A pay vehicle and structure that delivers ‘money for jam’, or even dangerous incentives in one situation, could promote desirable alignment in another. In practice, incomplete knowledge of parameters can lead to packages that fail to encourage appropriate executive actions (for instance, because there is inadequate reward for risk and effort) or actively encourage inappropriate ones (such as excessive risk-taking and ‘short-termism’). Some boards simply may not have been up to the task.

Furthermore, the increasing emphasis placed on equity and other incentive-based forms of remuneration in executive pay packages, particularly from the early 1990s, coincided with a period in which the sharemarket was rising relatively quickly, and economic conditions were for the most part, quite strong. In this environment, opportunities for company expansion and profit making were enhanced, and increased the extent to which executives could realise performance-related forms of remuneration. In other words, they might have benefited from good luck.

As noted earlier, Egan Associates suggested this may well have occurred over the 1990s, but that the 2000s:

> … was the beginning of the era when institutional investors were focusing on the need for performance hurdles … Increasingly, long-term equity-based incentive plans have required either fixed rates of growth in return or relative or absolute growth in total shareholder return, where performance equivalent to a market index represents a threshold and superior performance at the base of the top quartile of the market is the position at which all equity would vest. (sub. 105, p. 22)

Unfortunately, without comprehensive data relating to realised incentive pay, it is not possible to show whether there has been a change in realised outcomes. Based on a number of case studies, RiskMetrics (sub. 58) suggested that there had been a tendency for realised pay over the 2000s to exceed estimated values, although it was also acknowledged that the introduction of relative total shareholder return hurdles might mean that accounting fair values tend to overestimate costs to companies (box 3.3). (Because of executive risk aversion, the value to executives would be even less.) However, as discussed in chapter 3, in many of the cases cited, realised pay was less then initially estimated; indeed one-third lapsed. Moreover, actual outcomes will virtually never equal estimates based on estimated distributions (box 4.6). Realised amounts should also be compared in the same dollars as the earlier estimates and care has to be taken to distinguish between remuneration and wealth changes arising from capital gains (or losses). While capital gains, as changes in wealth, clearly contribute to an executive's income, they are not remuneration involving a payment from the company.

Nonetheless, that the parameters for payment of incentive pay have been progressively tightened, reflecting learning by boards as well as demands of institutional investors, provides some evidence that incentive pay may have been introduced without adequate understanding by boards. Further, incentive-based pay remains complex and challenging to design. Egan Associates commented:

> The complexity of reward structures has not transparently revealed that performance aligned awards reflect incremental and sustainable shareholder value creation. (sub. 105, p. 20)

Complexity might also have led to over-reliance by boards on outside advice. As Mercer said:

> … [remuneration] committee members generally lack the time and depth of technical knowledge to be deeply involved in the fine detail of remuneration design. (sub. 41, p. 6)

And Charles Macek submitted:

> The increasing complexity of remuneration arrangements has resulted in the establishment of Board remuneration committees and increased the need to engage remuneration consultants. (sub. 55, p. 5)

Box 4.6 **Estimated versus actual incentive pay**

Regnan considered that estimates of long-term incentive pay were overstated. In contrast, based on several case studies, RiskMetrics considered that realised pay tended to exceed estimated values.

If company valuation methods are reasonable then, over time, expected and realised aggregate values should converge (appropriately discounted for inflation and the timing of payments). But for individual cases, it is almost certain that estimates and actual amounts will diverge. Estimated values encapsulate the expected distribution of possible outcomes, but only one outcome can eventuate. For example, the ex ante valuation will take into account the likelihood of performance hurdles being met *and* not being met. In practice, the hurdles can only either be met *or* not met.

Estimates of incentive pay provide an estimate of the contingent liability being incurred by the company. For reasons noted earlier, the expected benefit to the executive generally will be (possibly significantly) less than this amount because of their risk aversion. Executive pay packages must be negotiated based on these company and executive estimates of costs and benefits of incentive pay arrangements.

Actual payments indicate how well executives have performed against performance hurdles. They also can reflect exogenous influences — on share prices, for example. Actual pay thus provides information about the accuracy of valuation methodologies over time.

And because there is no consensus about the best way of aligning incentives through pay (even in the academic literature), arrangements can be susceptible to fashion or fads. Boards, along with shareholders, might have taken comfort from following market trends. For example, there is currently some debate about the appropriateness of relative total shareholder return hurdles in a market downturn, although their widespread use arguably mitigated scope for rewards for good luck during the more recent sharemarket boom.

In practice, effective implementation of incentive-based pay is likely to require a continual process of evaluation, learning and adaptation by boards. From this perspective, arguably more telling indicators of the likely appropriateness of incentive pay arrangements are the processes boards follow to develop, monitor and adjust executive remuneration to achieve stated objectives, as well as the capacity of boards to understand such complex arrangements.

4.4 Broader market drivers of executive pay

The remainder of this chapter examines the influence of what can be described as broader market factors — represented in the left and right panels of figure 4.1. Possible 'supply-side' factors are considered first, followed by factors influencing the demand for executives.

Are executives *demanding* more?

Executives will be willing to offer their services at a (certainty equivalent, after-tax) 'price' that they consider compensates them for their effort, and the costs they have incurred in obtaining necessary skills and qualifications. They will also take into account amounts they could earn in other positions. Changes in any one of these factors could affect the remuneration they demand.

An international market for executives?

Overseas markets for executives provide alternative employment opportunities for domestically-based executives and could raise the level of remuneration required to induce executives to work for Australian-based companies. In addition, recruitment of candidates from nations where pay levels are higher than in Australia will likely require higher pay to match.

The US market may have been especially influential. US executive remuneration rose rapidly from the 1980s, coinciding with an increase in the issuance of incentive-based remuneration to executives, especially options. In 1993, the US Congress approved a law that placed a $1 million limit on the tax deductibility of 'non-performance' related executive remuneration, which some have argued prompted a shift in the composition of US executive pay away from base salary towards bonuses and options (chapter 10). While there are different views about the cause, the significant increase in the quantity of incentive pay granted to US executives has likely contributed to faster increases in their total level of remuneration.

Indeed, as noted earlier, Fernandes et al. (2009) conclude that the higher proportion of incentive pay in the United States explains a large part of the observed gap between CEO pay in the United States and the rest of the world. Further, they find that the gap is slowly closing as other countries, including Australia, progressively implement US-style incentive pay structures, and that convergence has been more rapid where non-US companies have appointed executives with international experience.

According to Mercer:

> The 1990s represent a turning point in the level and structure of Australian CEO pay. This decade saw a series of high profile Americans, appointed on US styles of pay, to lead Australian companies. The recruitment of people such as Bob Joss to Westpac Bank in 1990, Frank Blount (Telstra 1992), George Trumble (AMP 1994) and Paul Anderson (BHP 1998) were significant for Australian CEO remuneration … (sub. 41, p. 2)

Thus to the extent that overseas (especially US) pay structures became more common with international recruitment of executives, it is likely this contributed, in part, to changes in the quantum and structure of Australian executive remuneration. Nonetheless, the extent of this influence is contested.

ACSI (2009b) present data on the extent of international executive mobility between Australia and the rest of the world. The research indicates that between the 2003 and 2007 financial years for 50 of the largest ASX listed companies, 10 senior executive departures (around 4 per cent) were the result of international recruitment. Conversely, 35 newly-appointed executives (approximately 11 per cent) were recruited from abroad. Of the 28 CEOs appointed during the sample period, five were recruited from overseas (around 18 per cent).

So although relatively few Australian executives were recruited *by* overseas organisations, a significant number of executives were recruited from abroad. As recognised by the CEO of ACSI:

> The findings, while not providing compelling evidence of a global war for talent, were not necessarily inconsistent with there being substantial competition for senior executives. This is because pay arrangements and other changes may have been driven by companies responding to attempts to recruit their executives. (ACSI 2009b, p. 4)

Many other participants commented that international considerations, consistent with globalisation more generally, were playing an increasing role in selecting executives (box 4.7). Russell Reynolds Associates encapsulated these views:

> Global executive search, which used to be the province of mainly financial services, medical and academic sectors, has spread across all sectors … Whereas going back five years, probably 50% of our CEO work would require us to look offshore, it is now

> always the case for all our CEO level work. We can confidently say that 100% of our CEO assignments involve clients specifically asking us to look offshore. (sub. 59, attachment 4, p. 2)

The dominant channel through which 'trade in executives' appears to have contributed to a higher overall quantum of remuneration is via the need to match rates paid overseas (adjusted for cost of living and non-pecuniary factors) to attract senior executives to Australian companies. This in turn can have flow-on effects to other companies where executives have the potential to move to other positions, including abroad.

It should be noted, however, that average remuneration for Australian executives remains lower than for many other countries, and considerably so for the United States (chapter 3). This could reflect limited mobility in some sectors (for example, mining executives might have limited opportunities other than in Australian companies, in contrast with executives in the finance sector), as well as non-pecuniary and cost of living advantages. It could also indicate differences in corporate governance that mean that some Australian companies simply are not prepared to appoint candidates who demand what are perceived as distorted US rates of pay. As mentioned earlier, Fernandes et al. (2009) find that governance does explain some part of the observed difference in pay between US executives and those in the rest of the world.

Box 4.7 **International mobility of executives: inquiry participants' views**

BHP Billiton submitted:

> As a company that has global operations, the market for our purposes is a global market. (sub. 45, p. 3)

Woolworths commented:

> Shortages in skills in certain areas in Australia have led organisations to seek talent from overseas which also drives remuneration levels in the Australian market. There is a need to understand that the Australian labour market is influenced by both local and international labour markets. (sub. 91, p. 5)

With reference to the banking industry, the Australian Bankers' Association claimed:

> The relevant geographic market for bank executives is international. For example, of the last eight chief executive officers (CEOs) of Australia's major four banks, four were recruited from overseas. (sub. 70, p. 7)

The Australian Shareholders' Association noted:

> To an extent international competition for talent is a factor [increasing remuneration] and Australia's income tax system, currency and geographic isolation no doubt become factors in negotiations both in attracting executives from abroad and retaining executives in Australia. (sub. 54, p. 6)

Employment in non-disclosing entities?

It is impossible to quantify directly the range of alternative employment opportunities open to CEOs and other executives, but many participants noted that executives were able to shift to private equity companies and institutions such as hedge and superannuation funds that offered often higher rates of pay (in part to offset the 'illiquidity' of stock in these entities).

For example, Macquarie Group submitted:

> … in attracting and retaining executives and professionals, Australian publicly listed companies must compete with private organisations that can reward their executives and professionals well, without being subject to the same level of remuneration scrutiny as publicly listed companies. The last decade saw the rapid growth of such firms. (sub. 52, p. 3)

Egan Associates (sub. 105) agreed that rewards in private equity could be substantial (many times base salary) and that in effect executives are required to become significant investors in the company.

Employment risks

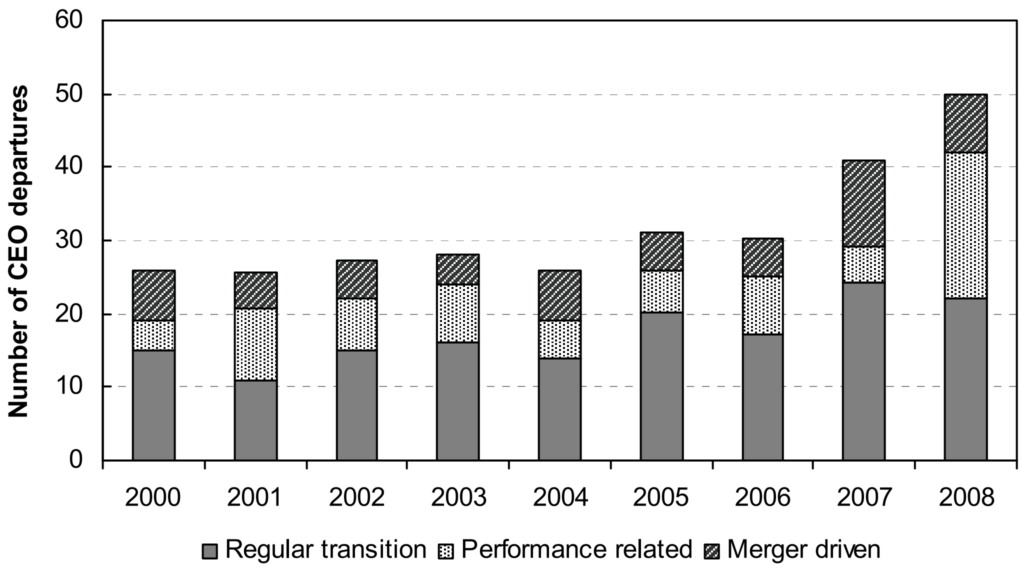
The risk of dismissal or redundancy and the associated reputational damage (with ramifications for future earnings) will influence the quantum of executive remuneration. All else given, to accept employment in a challenging position where there is a heightened risk of personal failure and thus of being fired, or a higher risk of firm failure and of being made redundant, executives, as for any employees, will naturally demand higher pay as compensation.

Figure 4.2 summarises results from a recent study by Manning and Mottram (2009) of CEO turnover among ASX200 companies since 2000. There was a small increase in turnover between 2000 and 2006 (from 26 departures to 30), before jumping to 41 in 2007, part of which was due to merger activity, but the bulk of which can be attributed to higher planned transitions (retirement, illness, or long-expected changes). In 2008 however, turnover increased again, rising to 50 CEO departures, including a rise in the number of forced departures from five to 20. This made forced departures almost as significant as planned transitions (which stood at 22), indicating that the risk of being fired for CEOs is nontrivial. Furthermore, this placed Australia's CEO turnover above the global average, at 22.3 per cent versus the global average of 14.4 per cent.

Unfortunately the survey does not specify how many planned CEO departures were retirements, and how many involved CEOs leaving their company to work in another organisation. Without knowing this, it is difficult to infer how many CEOs moved to positions overseas or to 'non-disclosing' institutions such as superannuation funds and private equity companies.

The number of *forced* CEO departures (as recorded) during this period averaged approximately eight per year, but is quite variable from year to year. Indeed, as noted, there was a sharp rise in the number of performance related departures in 2008, although it is not clear that this signifies a trend (excluding 2008, the average number of forced departures per year is seven). Hence, although employment risk is real for executives in ASX200 companies, it does not appear to have increased substantially, on average, over the period. Manning and Sherwood (2008) also reveal that CEO tenure in Australia was generally significantly lower than that experienced globally between 2000 and 2007 (5.9 years versus 7.7 years) (figure 4.3).

Figure 4.2 **CEO turnover, by reason for termination, Australia, 2000–08**[a]

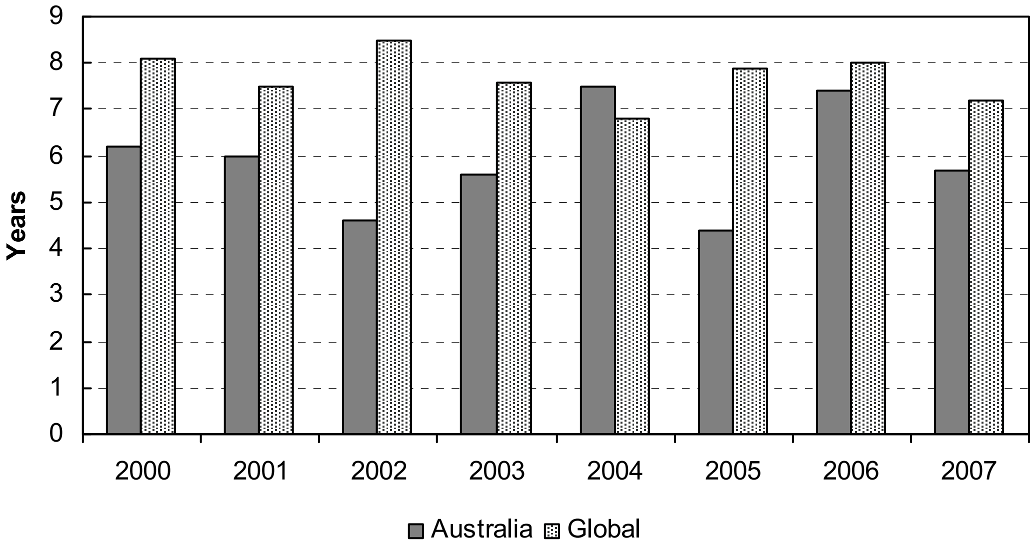


[a] ASX200 companies.

Source: Manning and Mottram (2009).

The study prepared by RiskMetrics for ACSI (ACSI 2009b) referred to earlier, analysed 333 executive appointments and 230 departures at 50 of the largest ASX companies between 2003 and 2007. The largest cause of executive departures between 2003 and 2007 was termination — accounting for around 36 per cent of all departures — suggesting that performance and conduct in employment are significant determinants of whether an executive retains employment (table 4.5). It is also likely that the termination data would tend to be underestimated given incentives for companies and executives to conceal acrimonious departures. (For example, 33 per cent of departures are classified as 'retired'.)

Figure 4.3 **Australian and global CEO tenure, 2000–07[a, b]**



[a] Australian data are based on ASX200 companies. Global data are based on the world's largest 2500 companies, based on market capitalisation. [b] Average tenure of departed CEOs.

Source: Manning and Sherwood (2008).

Table 4.5 **Reasons for senior executive departure, 2003–07[a]**

Reason for departure	*Departures*	*Proportion of all senior executive departures*
	no.	%
Terminated	82	35.7
Retired	76	33.0
Recruited — Australia	30	13.0
Divestment	16	7.0
Recruited — internationally	10	4.3
Resigned — reshuffle	9	3.9
Other	4	1.7
Death	3	1.3
Total	230	100.0

[a] Based on 50 of the largest ASX-listed companies between the end of the financial years 2003 and 2007.

Source: ACSI (2009b).

Has increased company 'size' led to higher pay?

In principle, companies will be prepared, at the limit, to pay executives up to the value of their contribution to company profits. This will be the product of the influence of the role an executive performs, as well as the abilities of the particular executive.

Chapter 3 documents strong positive correlation between company size and executive remuneration for Australia. This is consistent with numerous Australian and international studies on executive remuneration, some of which are discussed briefly in box 4.8 (with more detail in appendix D). The question addressed here is whether increased company size is a *driver* of increases in CEO pay.

The link between executive pay and company size has long been a matter of academic interest. Early studies debated whether executives had greater incentives to maximise the size or profitability of the companies they managed (box 4.9). This debate was at its most intense in the 1950s and 1960s, culminating in the work of Rosen (1982, 1992) which set out a theoretical explanation for the observed positive relationship. Rosen noted that the actions of executives can affect the productivity of employees at lower levels of the company hierarchy and thus have a *multiplicative* effect. This multiplicative effect increases with the number of hierarchical levels in the company.

An important consequence is that executive talent and company size should be positively correlated. Allocating the most talented executives to the largest companies maximises the effect of their greater ability by spreading it across longer chains of command and larger scales of operation (Rosen 1992, p. 184). Essentially, highly-talented executives are worth more to larger companies than to smaller ones — given that even a small difference in ability can make a significant difference to company performance — and competition between companies for the most talented executives will tend to result in relatively high levels of remuneration (Alchian and Allen 1983, p. 310).

Increases in company size could therefore have significant effects on remuneration by increasing competition for the most talented executives. This would also have flow-on effects for other executives in smaller companies. However, there would likely be some moderating influence from the effect of more people being enticed into the 'executive services market'.

Box 4.8 **Australian and US studies on remuneration and company size**

- Fleming and Stellios (2002) find a positive relationship between CEO remuneration and total assets for a sample of 86 ASX500 companies in 1999.
- Using a sample of 722 companies over the period 1990–99, Merhebi et al. (2006) find a positive relationship between CEO remuneration (defined as salary and bonuses) and company size (proxied by total revenue).
- Capezio (2008) also finds evidence of a positive relationship between CEO cash remuneration and company size (measured by total assets) for companies included in the ASX500 index between 1999 and 2006.
- In the United States, one of the earliest studies to document a positive relationship between executive remuneration and company size was Roberts (1956), using data on manufacturing executives in the late 1940s and 1950.
- Kostiuk (1990) finds a positive relationship between company size and the remuneration of manufacturing CEOs over the period 1969–81.
- Murphy (1999), using data for US S&P industrial companies between 1992 and 1996 finds that CEO remuneration is higher in larger companies, referring to this as 'the best-documented stylized fact regarding CEO pay' (p. 2493).
- Frydman and Saks (2007) document a positive relationship between company size and remuneration for the later decades of their data set (although the relationship between size and remuneration was found to be weak in the early decades of their sample).
- Gabaix and Landier (2008) use the observed relationship between size and remuneration to develop a model describing how CEO remuneration responds to changes in company size (considered in more detail in appendix D).
- Clementi and Cooley (2009), considering CEO remuneration for a large sample of US companies in 2002, find that remuneration tends to be higher in larger companies, and that CEOs of larger companies have bigger stock and option holdings (and hence more wealth) tied to the companies they manage.

As noted earlier, while there are probably many people with appropriate managerial training and experience, they will have different levels of desirable personal qualities — including communications skills, 'emotional intelligence' and leadership ability of a high order (box 4.10).

Box 4.9 **Company size, profitability and executive incentives**

The discovery of a positive relationship between company size and executive remuneration by studies such as Roberts (1956), led to debate over whether executives had greater incentives to increase company size or company profitability.

A number of studies addressing this question were undertaken, with some, such as McGuire, Chiu and Elbing (1962) finding a larger effect of sales than profits, but others, such as Lewellen and Huntsman (1970) found the reverse. Ciscel and Carroll (1980) argued that, because profit is equal to total revenue (sales multiplied by output prices) minus total costs, the significance of sales as an explanatory factor in analyses of executive remuneration could be consistent with both the size and profit maximisation hypotheses.

Rosen (1992, p. 196) concluded that there were no clear winners of this debate, and that both company size and performance are important. Furthermore, he argued that size should be positively related to remuneration in any case, since more talented executives worked at larger companies. Hallock and Murphy (1999, p. xiii) in observing this debate, make the point that sales and profits are both ultimately measures of company size, so the question of which one executives 'choose' to maximise is, in a sense, irrelevant.

In addition to the direct effect of growth in company size on demand for highly talented executives, growth in company size may also affect remuneration in an indirect way. As noted earlier in this chapter, Gayle and Miller (2008) have suggested that as company size increases, the potentially adverse consequences of inadequately addressing the principal–agent problem are magnified. As a result, larger companies can offer more incentive-based pay to their executives who, through risk aversion, require compensating differentials, resulting in higher overall pay. Sung and Swan (2009) find that the greater total dollar variability in company returns for large companies explains a significant part of observed remuneration growth in the United States.

A number of participants discussed the role of company size in executive remuneration in Australia. For instance, CGI Glass Lewis and Guerdon Associates stated:

> Theoretically, growth in market capitalisation would, to an extent, reflect additional company size and complexity, making it more difficult to source qualified executives. (sub. 80, p. 47)

Figures 3.3 and 3.4 in chapter 3 show that remuneration is typically significantly higher for companies that have a larger market capitalisation. This relationship holds for CEOs and other senior executives alike. For example, total CEO pay at the top 20 Australian listed companies is almost double that for the next twenty.

Box 4.10 What abilities should a CEO possess?

A number of personal characteristics affect the ability of a CEO to manage an organisation successfully, and thus, have implications for their suitability and the willingness of companies to pay for their skills.

Kaplan, Kelbanov and Sorensen (2008) outline a number of characteristics and abilities that a sought-after CEO is likely to possess, classified on the basis of leadership, interpersonal and motivational skills, and personal and intellectual abilities.

Desirable leadership qualities, for example, include the ability of a CEO to rapidly adjust to changing priorities or conditions, and produce significant output within a short period of time. Important interpersonal skills are the CEO's openness to criticism and ideas, and written and verbal communication skills. Motivational skills include the CEO's enthusiasm, initiative and work ethic. Personal abilities that companies are likely to seek in a CEO are those such as integrity, organisational and planning skills, and the likelihood that the CEO will follow through on commitments they have made. Intellectual abilities are those such as analytical skills, creativity, and attention to detail, in addition to brainpower (Kaplan, Kelbanov and Sorensen 2008).

That said, the correlation between remuneration, talent and company size is unlikely to be perfect, given the difficulty of making judgments about, and observing, the talent of individual executives. Other factors may also affect the relationship — for example, a highly-talented CEO may prefer (perhaps for non-pecuniary reasons) to work in a company smaller than the scale of company he or she is capable of managing. The observed relationship is also skewed by a few CEO/chairs who choose to take little direct salary, because they are substantial owners.[2] Indeed, based on an analysis of US data, Sung and Swan (2009) suggest that changes in executive 'talent' rather than company size *per se* explain a large part of CEO pay growth in the United States in the 1990s and early 2000s.

Nonetheless, simple regression analysis undertaken by the Commission provides some evidence that changes in company size are associated with changes in the level of executive remuneration (box 4.11).

[2] According to Fernandes et al. (2009), in the United States, CEO/chairs tend to receive higher pay than CEOs who do not perform both roles. The reason for the difference could be that Australian CEO/chairs are usually large owners who receive most of their rewards through equity holdings.

Box 4.11 **Regressing company size and remuneration**

In order to obtain a rough estimate of how changes in company size can lead to changes in executive remuneration, the Commission undertook some simple regression analysis. All of the estimates reported below were statistically significant.

- A regression was estimated using CEO remuneration as the dependent variable and company size, as proxied by market capitalisation, as the (sole) independent variable. Data were for 2003-04 to 2008-09, for all CEOs who served a full year in ASX300 companies.
- Regressing (the natural logarithm of) company size on (the natural logarithm of) total remuneration indicated that a 10 per cent increase in company size was associated with a 4.2 per cent increase in CEO remuneration (the latter figure is the elasticity of remuneration with respect to size). (Adding year dummies to the regression did not significantly alter the results or estimated magnitudes.) The (adjusted) R^2 was approximately 0.28, indicating that the specified model explained roughly 28 per cent of the variation in CEO total remuneration.
- Running a similar regression, but this time using base salary as the dependent variable, it was estimated that a 10 per cent increase in market capitalisation is associated with a rise in CEO base pay of around 3 per cent, accounting for around 20 per cent of the variation in CEO base pay.

For non-CEO executives, a similar regression of total remuneration on size was estimated for 2008-09. The results indicated that a 10 per cent rise in company size was associated with a 3.2 per cent increase in total non-CEO executive remuneration. This regression had an R^2 of 0.44, indicating that company size accounted for approximately 44 per cent of the variation in total executive remuneration. Running the same regression, but instead using base salary as the dependent variable returned an elasticity of 2.3 per cent (and an R^2 of 0.39).

Source: Appendix B, Productivity Commission estimates.

Using data on ASX300 CEOs and company size (proxied by market capitalisation) spanning the period 2003-04 to 2008-09, the regression estimates indicate that on average, a 10 per cent increase in company size is associated with an increase in total CEO remuneration of approximately 4.2 per cent. A similar analysis using base pay indicated that a 10 per cent increase in company size is associated with an increase in base pay of around 3 per cent. (Likewise, a 10 per cent decrease in a company's market capitalisation would be expected to result in a 3–4 per cent reduction in the remuneration of executives.) Similar results were found for non-CEO executives. The results are roughly consistent with those found in the US and Australian literature.

Thus, company size does seem to have played a major role in executive remuneration, accounting for between 25 and 50 per cent of observed increases in total remuneration. Although perhaps the most significant individual driver of remuneration, it is not the only explanation for the observed increase in remuneration over time.

4.5 Some conclusions

The economic environment confronting Australian companies in the 2000s is far more complex and pressured than in the 1960s. Liberalisation of product and financial markets, as well as the introduction of competition in some formerly government-controlled sectors, culminated in increased international trade and financial flows and drove substantial domestic structural change, including corporate consolidation and the emergence of Australian-based global companies. In 1968-69, Australia's trade intensity (defined as the ratio of imports and exports to gross domestic product) was around 26 per cent, rising to 33 per cent by 1988-89. By 2008-09 it was 47 per cent (ABS 2009c).

In parallel with these developments, executive pay has both increased and changed in form. Until the late 1980s, executive remuneration comprised mainly cash, perquisites, with small bonuses and some equity granted as profit sharing. Since then, executive pay growth has been driven by increases in incentive pay, a trend accelerated by the 'importation' of a few high profile US executives to key CEO positions. Such a change was probably inevitable, however, given the increasingly international focus of Australian companies.

While it is not possible to be categorical about all the reasons for the substantial remuneration increases, the dominant influences appear to be:

- The growth of Australian companies in a more dynamic and global environment, which raised the importance of the most highly-talented executives for the largest companies. In essence, both job requirements and job opportunities changed.
  - Increased demand led to increased remuneration for the best executives, with ripple effects for the remuneration of other executives.
  - Globalisation increased the mobility of executives and the demand by companies for people with international experience (with some 'imported' effects from high executive pay in the United States via the appointment of particular executives).
- Enhanced disclosure rules are likely to have accelerated pay adjustments across the executive market to realign relativities, but there is little evidence that they led to a permanent lift in the growth of executive pay.

- The growth of incentive pay has accounted for nearly all the growth in executive pay at larger companies in recent years.
  - Increasing company size appears to have led to strong growth in incentive pay, reflecting the potential benefits of closer incentive alignment (and bigger risks of imperfect alignment) for larger companies.
  - Even if efficiently set, a shift to incentive pay will have served to increase reported total pay because of the additional risks it poses for executives.
  - Initially, incentive pay may not have been closely aligned to improving performance, leading to higher than necessary payments and the more rapid overall growth seen in the 1990s. The progressive introduction of relative performance hurdles from the mid 2000s may have ameliorated this to some degree, although at the cost of introducing complexities to pay structures.
- Although Australia's corporate governance appears stronger than that in the United States, not all companies meet best practice requirements.
  - Where potential conflicts of interests persist, there is potential for executives to exert undue influence either directly or indirectly.
  - Board weakness or complicity as well as information asymmetry may have been factors in several instances of apparent 'rewards for failure'.
  - The complexity of incentive-based pay raises concerns that boards may not have possessed the requisite capacities to understand their implications, becoming excessively reliant on external advice. Companies might thereby have ended up paying too much for little positive (and sometimes negative) incentive effect.

In summary, there are reasonable grounds for concluding that, to a significant degree, changes in executive remuneration in Australia can be related to market developments and pressures, and endeavours by boards to align executive effort with company interests. Nevertheless, there are also indications that some trend and specific pay outcomes have been inconsistent with an efficient executive labour market. The complexities of incentive pay arrangements have heightened the importance of having competent, independent boards and good processes to ensure that objectives are not being subverted. The extent to which Australian companies meet these criteria is the focus of the following chapters.

PART C

ASSESSING THE REMUNERATION ENVIRONMENT

5 Overview of the regulatory and corporate governance framework

Key points

- Corporate governance encompasses rules as well as the framework of relationships and processes designed to ensure that company managers and directors act in the interests of the company and, ultimately, shareholders.
- Reflecting changes in companies and market expectations, Australia's corporate governance framework has evolved significantly over time.
- To accommodate diversity and to balance objectives, the regulatory and corporate governance framework comprises a mix of:
  - 'black letter' law, through the *Corporations Act 2001* (Cwlth) and the ASX listing rules
  - 'soft' law, under the ASX Corporate Governance Council principles and recommendations ('if not, why not' reporting)
  - non-regulatory guidelines promulgated by industry organisations.
- The regulatory and corporate governance framework influences:
  - the way boards function
  - how boards choose to link pay to performance
  - disclosure of director and executive pay
  - how effectively boards engage with the company's shareholders.

The terms of reference for this inquiry require the Commission to consider the effectiveness of the framework for the oversight, accountability and transparency of remuneration practices in Australia, including the role of regulatory and non-regulatory industry guidelines and codes of practice.

'Corporate governance' refers to the set of institutions and practices designed to ensure that managers and directors act in the interests of the company and ultimately shareholders. It encompasses:

> … 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations'. It encompasses the mechanisms by which companies, and those in control, are held to account. (ASX Corporate Governance Council 2007a, p. 3, citing Justice Owen in the HIH Royal Commission)

Thus corporate governance is not simply a product of government regulation. Companies have inherent incentives to establish governance procedures to demonstrate their bona fides to investors, in order to attract capital. Executives also have incentives to deliver good performance to maintain their professional reputations. But rules can reinforce such incentives and diminish the risk of a loss of confidence in a market resulting from poor behaviour of a few.

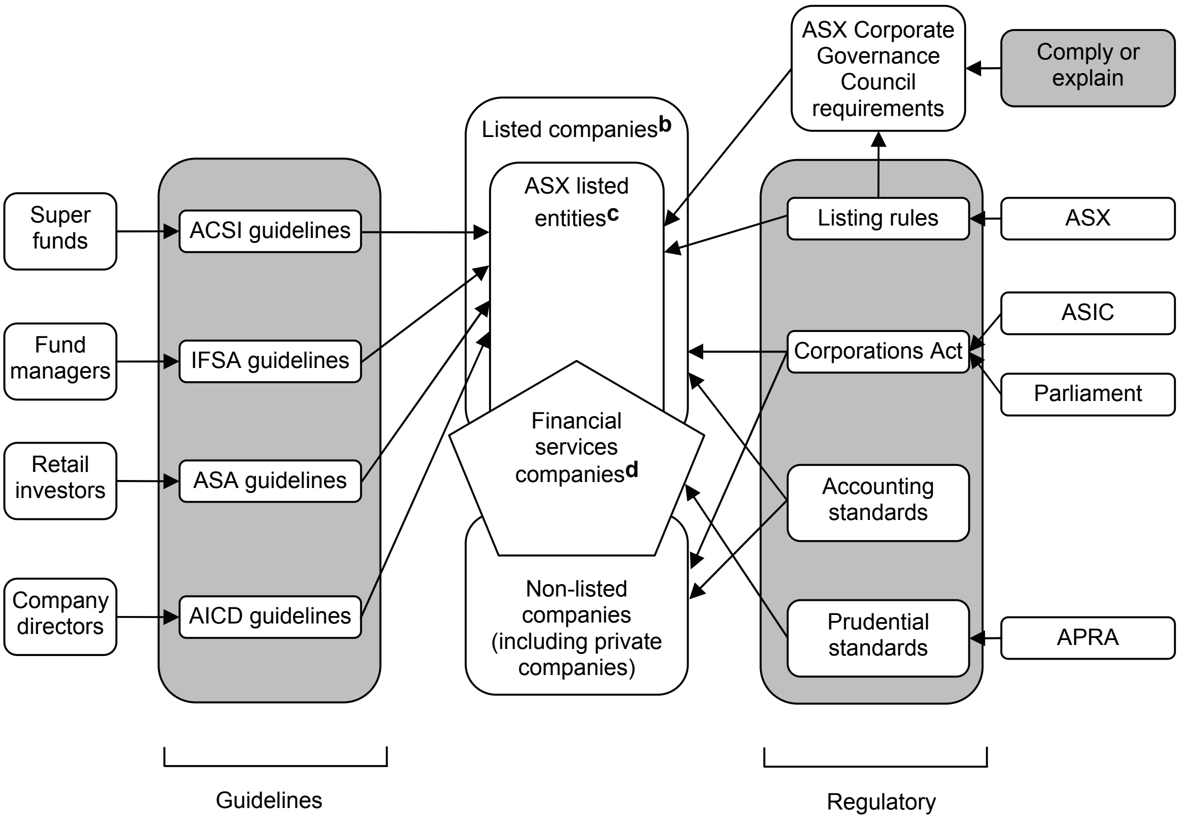
There is no single or enduring best-practice model for corporate governance: different approaches and combinations of approaches can promote alignment and trust, while company structures and market expectations change over time. Indeed, the diversity of companies makes flexible governance arrangements highly desirable — one size is unlikely to fit all. In addition, regulations designed to promote alignment and accountability, if they are excessively prescriptive, have the potential to impede the ability of managers to manage. To accommodate diversity and to balance objectives, Australia's corporate governance framework has accordingly evolved over time, combining 'black letter' law with 'soft' law requirements, as well as other industry-based guidance.

Internationally, Australia's corporate governance framework ranks highly. Australia has consistently been ranked in the top three countries for the efficacy of its corporate boards since 2002-03, according to the World Economic Forum (2008). (Efficacy is assessed by the extent to which survey respondents considered that investors and boards exert strong supervision of management decisions.) Similarly, analysis by GovernanceMetrics International in 2008 ranked the top Australian companies fourth among companies from 38 countries, against criteria such as board accountability, financial disclosure and internal controls, shareholder rights, executive remuneration, market for control and ownership base, and corporate behaviour (GovernanceMetrics International 2008).

5.1 Australia's current framework

Australia's regulatory framework for remuneration — and corporate governance more broadly — has over time brought greater disclosure, accountability of directors and involvement of shareholders. The framework is based on a mix of regulations ('black letter' law), 'comply or explain' guidelines ('soft' law) issued by the Australian Securities Exchange (ASX) Corporate Governance Council, and advisory guidelines. Figure 5.1 illustrates how these regulations and guidelines interact.

Figure 5.1 **The regulatory and governance framework**[a]



[a] Acronyms are as follows — ACSI: Australian Council of Super Investors; AICD: Australian Institute of Company Directors; APRA: Australian Prudential Regulation Authority; ASA: Australian Shareholders' Association; ASIC: Australian Securities and Investments Commission; ASX: Australian Securities Exchange; IFSA: Investment and Financial Services Association. [b] Listed public companies will predominantly be ASX-listed entities. Exceptions are companies listed on other Australian stock exchanges, such as the National Stock Exchange of Australia and the Bendigo Stock Exchange. [c] Most ASX listed entities would be listed public companies in the context of the Corporations Act. Exceptions include some listed trusts and companies incorporated outside Australia. [d] Some APRA-regulated banks and insurance companies would be ASX-listed entities. However many, including credit unions, building and friendly societies, and superannuation funds are not ASX listed.

The 'black letter' regulatory framework for companies in Australia is centred on the *Corporations Act 2001* (Cwlth) and the ASX listing rules. Together, these form the core of the regulatory requirements placed on companies with regard to issues such as board structure, disclosure, shareholder voting and corporate governance.

The Corporations Act

The Corporations Act is the principal legislation regulating companies. (Prior to 2001, the Corporations Law was contained in a Commonwealth Act that was enacted in the ACT, with State and Northern Territory laws applying the Corporations Law of the ACT.) The Act is obviously much broader in its coverage than executive remuneration, and includes the framework surrounding the formation of companies and the duties of directors (box 5.1).

The Corporations Act applies, though to differing degrees, to private and public companies and some partnerships and managed investment schemes. Public companies are subject to more stringent disclosure and reporting requirements than private companies.

Box 5.1 **The Corporations Act**

The Corporations Act provides the statutory basis for the formation of private and public companies, corporate regulation and the regulation of the securities and futures industries.

Although the Australian Constitution provides that the states have jurisdiction over corporations, the states and territories have formally referred their powers on corporations and securities to the Commonwealth. These arrangements are supported by the intergovernmental *Corporations Agreement 2002*. The agreement requires consultation with the states and territories and, in some cases, voting on amendments to the Corporations Act and related legislation (through the Ministerial Council for Corporations). This can have implications for executive remuneration (chapter 9).

The coverage of the Corporations Act is wide ranging, including:

- registration of companies
- membership and internal management (including the duties of directors)
- financial reporting and disclosure
- takeovers
- fundraising
- financial services and markets.

These provisions apply to differing degrees to private and public companies and some partnerships and managed investment schemes. In relation to executive remuneration, for all companies, the role and composition of boards and termination benefits are regulated. For listed companies, the Act regulates disclosure through the remuneration report and voting on remuneration.

With respect to executive remuneration, the Corporations Act has provisions relating to the role, responsibilities and structure of boards; termination payments; and, for listed companies, disclosure (through the remuneration report) and voting on remuneration. Under the Act, the board of directors is responsible for appointing the managing director (CEO), and deciding the composition of the managing director's remuneration package. While not explicitly mentioned in the

Corporations Act, the board also has a key role in setting remuneration for other senior executives.

The Corporations Regulations 2001 also require companies to prepare their annual financial report, including the remuneration report, in accordance with the applicable accounting standards, including valuing share-based payments. Sanctions for breaches of Corporations Act provisions involve fines and, in some cases, imprisonment.

The provisions in the Corporations Act relating to remuneration have strengthened over time, in response to emerging concerns. In particular, disclosure requirements have increased to improve transparency and accountability (box 2.1 in chapter 2). A non-binding vote on the company's remuneration report was introduced in 2004 and, more recently, the threshold for a shareholder vote on termination payments was lowered considerably.

Under the Corporations Act shareholders are responsible for the election of directors. Further, section 203D states that a director may be removed by ordinary resolution of the company. This resolution may be put to the general meeting by shareholders with 5 per cent of the votes that may be cast on the resolution, or at least 100 shareholders (s. 249N). Notice that the resolution is to be put to the meeting must be received by the company at least two months before the meeting.

Many of the reforms to the Corporations Act were implemented under the auspices of the Corporate Law Economic Reform Program (CLERP). This program of sequential reforms, designed to comprehensively improve Australia's corporate law, began in 1997 in response to the Wallis report into the Australian financial system. Central to the program were principles of market freedom, investor protection and quality disclosure of relevant information to the market (Treasury 2002).

CLERP reforms were undertaken in nine stages — commonly referred to as CLERP 1 to 9 — the last of which was enacted in July 2004 (box 5.2). Among other reforms (including in response to the HIH Insurance Royal Commission), CLERP 9 introduced the non-binding vote on remuneration and increased remuneration disclosure.

Box 5.2 **Corporate Law Economic Reform Program**

The Corporate Law Economic Reform Program (CLERP) involved a series of staged reforms aimed at improving Australia's corporate law.

- CLERP 1 reformed the accounting standard-setting process, and included reconstituting the Australian Accounting Standards Board and establishing the Financial Reporting Council.
- CLERP 2 reduced the cost of fundraising for Australian companies by improving disclosure and reducing transactions costs.
- CLERP 3 focused on directors' duties and corporate governance, and included the introduction of a 'business judgment rule'.
- CLERP 4 reformed takeover regulation, including notification requirements and procedures.
- CLERP 5 facilitated electronic commerce, including improved flexibility for electronic lodgment and inspection of information.
- CLERP 6 involved significant reform to financial services markets, establishing a regulatory framework for the financial services industry and establishing the Australian Prudential Regulation Authority.
- CLERP 7 simplified document lodgment and compliance procedures.
- CLERP 8 enacted a model law on cross-border insolvency, developed by the United Nations Commission on International Trade Law.
- CLERP 9 aimed to improve the operation of the market by promoting transparency, accountability and shareholder activism. With respect to executive remuneration, it extended the scope of remuneration disclosure, introduced the non-binding vote on the remuneration report and required shareholder approval for retirement benefits for directors and managerial officers.

Source: Treasury (2009c).

ASX listing rules

The ASX listing rules deal with the requirements for listing and quotation, market information, trading and settlement, and general supervisory matters. The rules apply to all companies and trusts (entities) listed on the ASX. Most of these entities will also be subject to the requirements of the Corporations Act (exceptions include some listed trusts and companies incorporated outside Australia). ASX listing rules date from the formation of the Australian Stock Exchange in 1987, but like the Corporations Act have evolved over time.

The listing rules are designed to protect investors and the reputation of the market, while taking into account the interests of listed entities (ASX 2009f). The ASX sets these rules, but under the Corporations Act, any amendments must be lodged with the Australian Securities and Investments Commission and are subject to disallowance by the relevant Minister.

Key listing rules affecting executive remuneration relate to continuous disclosure, issuing shares to related parties, voting on non-executive director remuneration, reporting against the ASX Corporate Governance Council's recommendations (discussed further below) and some voting exclusions (box 5.3).

Listed companies and trusts enter into a binding contractual relationship with the ASX to comply with its listing rules. In addition, the rules are enforceable under the Corporations Act against listed entities and their associates (ASX 2009f). A breach of the ASX listing rules can result in a variety of sanctions against the company — ranging from censure or compulsory director education for minor breaches, to suspension or fines of up to $1 million for serious breaches (ASX 2008b).

APRA and financial services businesses

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the financial services industry, including banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. A key reason for specialised regulation of the financial services industry is the risk of third party losses and impacts on the wider financial system from individual corporate failures.

Some companies regulated by APRA are also subject to the Corporations Act and the ASX listing rules. However, many — including credit unions, building and friendly societies, and superannuation funds — are not listed. Those that have issued debentures are subject to the Corporations Act.

APRA recently finalised and released a set of prudential standards that would require APRA-regulated businesses to have a remuneration committee and a remuneration policy that aligns remuneration with risk management. These standards come into effect on 1 April 2010 (box 5.4).

Box 5.3 **ASX listing rules affecting executive remuneration**

ASX listing rules affecting executive remuneration relate to the following areas.

- Disclosure:
  - continuous disclosure — once an entity becomes aware of information that a reasonable person would expect to have an effect on the entity's securities, the entity must immediately inform the ASX. Under this rule, when a senior executive is appointed, the entity must immediately disclose to the ASX the contractual terms (listing rule 3.1)
  - the extent to which the ASX Corporate Governance Council's recommendations have been complied with, and if not, reasons why (listing rule 4.10.3).
- Non-executive director remuneration and re-election:
  - an entity must not increase the total amount of director fees payable without shareholder approval by ordinary resolution (this rule does not apply to executive directors) and non-executive director remuneration must be a fixed sum (listing rule 10.17)
  - directors must submit for re-election at the third annual general meeting following appointment, or after three years, whichever is longer (the rule does not apply to the managing director/CEO of the entity — if there is more than one managing director, only one is not subject to re-election) (listing rule 14.4).
- Other shareholder voting:
  - for a director to obtain a substantial asset (valued at more than 5 per cent of the company's outstanding equity) from the company (listing rule 10.1)
  - for the issue of shares to a related party (including a director) (listing rule 10.11)
  - for a director to obtain equities under an incentive scheme, that are not purchased on the market (listing rule 10.14)
  - for total termination benefits that exceed 5 per cent of the company's equity (listing rule 10.19)
  - for the issue of total equity, within a 12 month period, that exceeds more than 15 per cent of outstanding equity (listing rule 7.1)
  - voting exclusions for certain resolutions including those relating to issuing equity, the directors' fee pool and significant termination payments (various listing rules).
- Prohibits a senior executive receiving a termination payment due to a change in the control of the company (listing rule 10.18).

Sources: ASX listing rules.

Box 5.4 **APRA's review of regulatory arrangements for remuneration in financial institutions**

APRA has finalised its consideration of remuneration for authorised deposit-taking institutions and general and life insurance companies, following a request from the Prime Minister to consider links between remuneration and capital adequacy requirements. APRA's proposals also implement the Financial Stability Forum's *Principles of Sound Compensation Practices*, endorsed by the G-20 in April 2009 (APRA 2009b). APRA released its finalised governance prudential standards and prudential practice guide on 30 November 2009, to be effective from 1 April 2010.

APRA's approach to remuneration, in broad terms, focuses on the structure, rather than quantum, of remuneration (APRA 2009a, 2009d). APRA views the board of directors as ultimately responsible for remuneration. However, it proposes two key extensions to existing governance standards — requiring boards to establish, maintain and periodically review a written remuneration policy, and requiring boards to establish a remuneration committee (APRA 2009c).

Remuneration policy

The remuneration policy covers all persons or classes of persons within the institution who, given their roles, have the ability to make decisions that could put the institution's financial soundness at risk. Employees covered by the remuneration policy include: 'responsible persons' (generally directors, executives and senior managers), risk and financial control personnel, and other staff who have a significant share of remuneration that is performance-based (such as bonuses and commissions). Non-executive directors however, are excluded.

Remuneration committees

Remuneration committees should comprise only non-executive directors, with a majority independent and an independent chair (consistent with audit committee requirements). The remuneration committee should be responsible for periodically reviewing the institution's remuneration policy (at least every three years) and making annual recommendations to the board on the remuneration of the CEO, direct reports to the CEO, persons whose activities may affect the financial soundness of the institution, and any other person specified by APRA. APRA may grant approval to an institution not to have a remuneration committee if the board has alternative arrangements in place that achieve the same result.

Risk

APRA's prudential practice guide (to assist institutions comply with the requirements) states that sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets. APRA suggests that generally, prudent practice entails a substantial portion of performance-based remuneration being deferred and at risk for an extended period. APRA indicates that measuring performance by profits or earnings may be appropriate in some cases, but effective remuneration arrangements will include adjustments for risk, including future risks not identified or measured by accounting profits (2009b).

ASX Corporate Governance Council's principles and recommendations

Complementing the statutory or 'black letter' law requirements are 'soft' law corporate governance principles and recommendations of the ASX Corporate Governance Council, which have some regulatory force. The council's key recommendations on board structure and remuneration are presented in box 5.5.

Box 5.5 ASX Corporate Governance Council's principles and recommendations on board structure and remuneration

The first edition of the ASX Corporate Governance Council's corporate governance principles and recommendations was released in 2003 (ASX Corporate Governance Council 2003). Revised principles and recommendations were issued in 2007.

The principle on structuring the board (principle 2) contains four 'comply or explain' recommendations:

- the board should be made up of a majority of independent directors (recommendation 2.1)
- the chair should be an independent director (recommendation 2.2)
- the chair and the chief executive officer should not be the same person (recommendation 2.3)
- a nomination committee should be established (recommendation 2.4) (ASX Corporate Governance Council 2007).

The principle on remuneration (principle 8) states 'companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear' (ASX Corporate Governance Council 2007, p. 35). It contains three recommendations:

- the board should establish a remuneration committee (recommendation 8.1)
- companies should clearly distinguish the structure of non-executive director remuneration from executive remuneration (recommendation 8.2)
- the board should provide the following information (recommendation 8.3):
  - the names of the members of the remuneration committee or, if the company does not have a remuneration committee, how its functions are carried out
  - the existence and terms of any retirement benefit schemes (other than superannuation) for non-executive directors
  - a summary of the company's policy on hedging unvested performance pay.

The ASX Corporate Governance Council involves a mix of 21 business, investment and shareholder groups (including representatives of many of the authors of key advisory guidelines, as discussed below). The council was established in 2002 to develop and deliver an industry-wide, supported framework for corporate governance that would provide a practical guide for listed companies, their investors and the wider Australian community.

Reflecting the diversity of listed companies, a cornerstone of the principles and recommendations is flexibility, balanced with accountability. Companies are not *required* to comply with the ASX Corporate Governance Council's recommendations. However, under ASX listing rule 4.10.3, they must disclose whether they have complied with the recommendations and if they have not, provide a public explanation (the 'if not, why not' rule).

Advisory guidelines

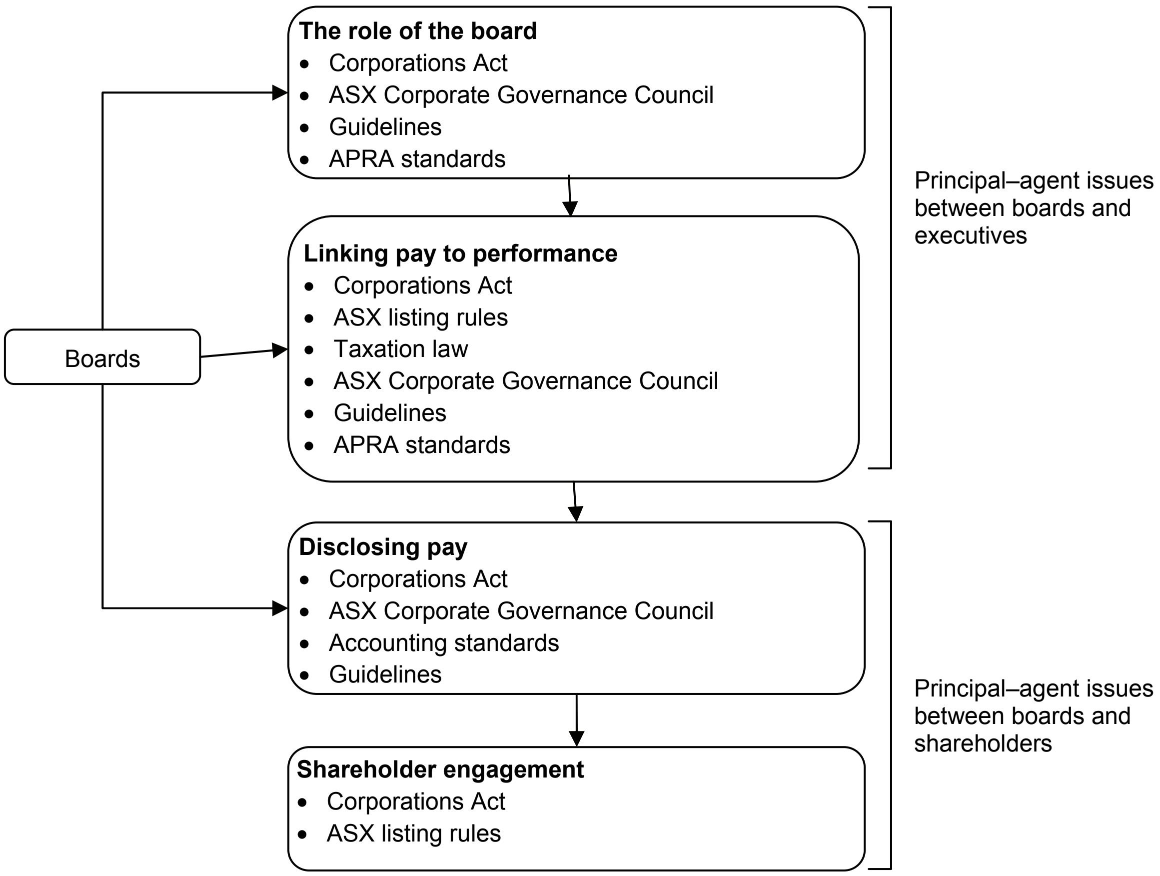
Other guidelines are issued by organisations such as the Australian Council of Super Investors, the Australian Shareholders' Association, the Australian Institute of Company Directors and the Investment and Financial Services Association. These organisations cover a variety of key stakeholders, including both institutional investors (organisations such as superannuation funds and mutual funds) and retail investors (individuals). While their guidelines are directed at boards, they also give their members a point of reference when engaging with companies and voting on corporate governance matters.

In addition, individual institutional investors and proxy advisers (who offer advice to institutions on how to vote their shares, such as RiskMetrics and CGI Glass Lewis) often follow their own guidelines when deciding or recommending how to vote. Thus such guidelines can influence remuneration practices through the threat of a negative vote on companies' remuneration reports or at board elections.

The 'framework' for remuneration

Taking into account the above regulatory requirements, the remuneration framework focuses on the role of the board in setting remuneration, including linking pay to performance, remuneration disclosure, and shareholder voting. Figure 5.2 depicts the elements of this framework, and the main regulations and guidelines affecting each, broken down according to the two agency relationships involved. Table 5.1 highlights which regulations and/or guidelines affect different aspects of remuneration.

Figure 5.2 **How regulations affect the executive remuneration framework**



To assist in determining an appropriate executive remuneration package, guidelines recommend boards establish a remuneration committee, and seek independent external advice from remuneration consultants. Remuneration packages typically comprise fixed pay, and short- and long-term incentive payments. These can be in the form of cash or equity. Each of these forms of pay have different guidelines and regulations surrounding their use. For example, non-recourse loans, termination payments and the use of hedging for unvested incentive payments all feature prominently within advisory guidelines (table 5.1). Taxation provisions can also influence the structure of remuneration.

Each year, companies are required under the Corporations Act to produce a 'remuneration report' as part of their annual report. The Act specifies the information that needs to be provided in the report. Shareholders have a (non-binding or advisory) vote on this report at the annual general meeting. They also have a binding vote on termination payments above a certain threshold (recently reduced), as well as on remuneration involving the issue of equity to directors, and the election of directors (chapters 8 and 9).

Table 5.1 **Remuneration regulation**[a]

	Regulatory/'comply or explain'				Guidelines			
	Corporations Act	ASX listing rules	APRA	ASX CGC	AICD	ACSI	ASA	IFSA
The role of the board								
Composition of boards	✓			✓	✓	✓	✓	✓
Remuneration committee			✓	✓	✓	✓		✓
Remuneration consultants			✓		✓	✓		
Linking pay to performance								
Equity-based pay		✓	✓		✓	✓	✓	✓
Non-recourse loans					✓	✓	✓	✓
Hedging	✓		✓	✓		✓	✓	
Termination benefits	✓	✓	✓		✓	✓	✓	
NED remuneration		✓		✓	✓	✓	✓	
Disclosing pay								
Remuneration report	✓			✓	✓	✓	✓	✓
Executive contract		✓						
Shareholder engagement								
Issue of equity		✓			✓			✓
Termination benefits	✓	✓			✓			
Remuneration report	✓				✓			
NED remuneration		✓						

[a] Acronyms are as follows — ACSI: Australian Council of Super Investors; AICD: Australian Institute of Company Directors; APRA: Australian Prudential Regulation Authority; ASA: Australian Shareholders' Association; ASIC: Australian Securities and Investments Commission; ASX: Australian Securities Exchange; ASX CGC: Australian Securities Exchange Corporate Governance Council; IFSA: Investment and Financial Services Association.

Sources: ACSI (2009a); AICD (2004, 2009b); APRA (2009b, 2009c); ASA (2009); ASX listing rules; ASX Corporate Governance Council (2007a); *Corporations Act 2001* (Cwlth); IFSA (2009).

The process for determining remuneration for non-executive directors differs from that for executives. Shareholders have a *binding* vote on any increases to the total pool of non-executive director fees. Once this pool is determined, the board can then decide how to allocate the fees. Generally the pool is divided equally, with additional fees allocated to directors on committees, the chairs of the committees and the chair of the board.

5.2 Approach to assessing effectiveness

The evaluation task entailed in meeting the terms of reference to assess the effectiveness of the regulatory and corporate governance framework is presented in five chapters in this part of the report. Specifically, part C assesses how the existing framework influences and constrains boards in relation to their deliberations on pay quantum, pay structure and engagement with shareholders. The chapters are structured to reflect the remuneration framework presented in figure 5.2 and table 5.1.

The following two chapters focus on the framework primarily addressing principal–agent issues between boards and executives. The role of the board, including the use of remuneration committees and remuneration consultants, is assessed in chapter 6. Linking pay to performance is discussed in chapter 7.

Agency issues between boards and shareholders are addressed through shareholder engagement in remuneration processes and outcomes, including remuneration disclosure (primarily the remuneration report) and shareholder voting. The effective functioning of disclosure and the remuneration report is assessed in chapter 8 and other shareholder engagement areas are discussed in chapter 9.

The final chapter in part C deals with taxation (chapter 10). Boards essentially take tax arrangements as given, but they can respond to tax-induced incentives in different ways. That said, taxation arrangements have wider implications than just executive remuneration and this is reflected in the scope of that chapter.

In all of these areas, Australia's current arrangements are compared with international approaches. Effectiveness is assessed, problems identified and possible improvements are discussed. However, given the significant overlaps and interactions between 'black letter' law, 'soft' law and regulatory guidelines, in tandem with the potential for policy changes in one area to affect others, the analysis and conclusions in part C are considered in a more integrated way in part D along with policy options.

6 Assessing the role of the board

Key points

- Independent, well-informed decision-making, including on executive remuneration, is in the best interests of a company and its shareholders. Board members therefore require a mix of skills, knowledge and experience.
- While ultimately it is up to shareholders to elect the most suitable board candidates to represent their interests, the board plays the pivotal role in endorsing candidates and managing director performance.
- Accordingly, it is important that the processes for board selection and renewal work well.
  - The lack of diversity in the membership of Australia's boards — particularly the very low (and declining) participation of women — suggests that many companies are not adequately utilising available talent.
  - The current use of the so-called 'no vacancy' rule by some boards makes it harder for shareholders to elect candidates not endorsed by boards.
- Increased liability of directors under various corporate and other laws may be reducing the pool of suitable candidates for directorships.
- Many boards establish remuneration committees to reduce the potential for conflicts of interest in setting executive remuneration and more effectively utilise board members with specialist skills and knowledge.
  - The current 'if not, why not' requirement is appropriate in encouraging boards to establish remuneration committees, accommodating the circumstances of smaller companies.
- Strengthening remuneration committee independence, including protocols for non-committee members attending meetings and the use of specialist advisers, could reduce potential conflicts of interest when setting executive remuneration.
- Many boards seek advice from remuneration consultants to inform decisions on executive remuneration. Consultants can usefully augment board skills and experience in this area.
  - However, potential for conflicts of interest can arise, particularly where consultants do not report directly to the board, or where they provide other services to the same company.
  - Improved disclosure could help shareholders assess the independence and value of external advice to boards and their remuneration committees.

Given the board's central role in determining remuneration for the chief executive officer (CEO), senior executives and directors, a well-functioning board is fundamental to achieving the most appropriate remuneration outcomes for a company. In particular, as discussed in chapter 4, the independence from management of board decision-making, as well as the capacity of boards, is important for executive remuneration decisions.

6.1 The central role of the board

The *Corporations Act 2001* (Cwlth) specifies that the business of a company should be managed by, or under the direction of, the directors on behalf of shareholders (section 198A). It is the board's responsibility to identify an organisation's strategy and goals, and it is management's responsibility to decide how to implement these (AICD 2007d).

The board of a public company must have at least three directors. Generally, companies specify in their constitution a minimum and maximum number of board members. In 2008, for a sample of 87 ASX100 companies, average board size was 8.8 (ACSI 2009c). Further, Korn/Ferry International and Egan Associates (2008) found that for the top 300 companies in 2008, on average three-quarters of directors on the board were non-executive directors (NEDs), with the ratio of NEDs to executive directors decreasing the smaller the company.

Directors have a range of legal duties that are set out in the Corporations Act. They are required to exercise their powers in the best interests of the company, to take reasonable steps to comply with financial recording and reporting requirements, and to disclose any material personal interests or significant information under Australian Securities Exchange (ASX) listing rules.

A key role of the board is to appoint the CEO and determine remuneration packages for directors and the executive team (chapter 2).

According to the ASX Corporate Governance Council, the board should be structured in such a way that it:

- has a proper understanding of, and competence to deal with, the current and emerging issues of the business
- exercises independent judgment
- encourages enhanced performance of the company
- can effectively review and challenge the performance of management. (2007a, p. 16)

Independence of boards

Independent decision-making is a basic requirement for an effective board. All directors — including executive directors — should bring their own objective judgment to bear on board decisions (ASX Corporate Governance Council 2007a). The 'independence' of directors is not defined in the Corporations Act and boards generally adopt their own definition. The ASX Corporate Governance Council defines as independent a NED who is free of any business or other relationship that could materially interfere with the independent exercise of their judgment, or be perceived to do so (ASX Corporate Governance Council 2007a). Box 6.1 lists factors identified by the ASX Corporate Governance Council that can affect the independence of a director.

Box 6.1 **The independence of directors**

When determining the independent status of a director the board should consider whether the director:

- is a substantial shareholder of the company (a person with a 'substantial holding' as defined in the Corporations Act) or an officer of, or otherwise associated directly with, a substantial shareholder of the company
- is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board
- has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
- is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
- has a material contractual relationship with the company or another group member other than as a director.

Source: ASX Corporate Governance Council (2007a, p. 17).

In contrast, the Australian Prudential Regulation Authority (APRA) has adopted a stricter approach, and explicitly states that particular circumstances (adapted from the ASX Corporate Governance Council's guidance, see box 6.1) will not meet its test of independence (APRA 2009e). Thus, under APRA's standards a director who falls into one of these categories can not be independent.

Both APRA's and the ASX Corporate Governance Council's definitions and guidance relating to 'independence' have been criticised by the Australian Institute of Company Directors (AICD) for being too explicit and for conferring independent status according to 'a relationship-based definition' (AICD 2007a). The AICD argue that questions of independence should be concerned with independence of mind and a willingness to act and make a difference in the boardroom. They do not consider that this is properly addressed by governance rules about prior business associations (AICD 2008b). While this argument has merit in principle, relationship-based definitions are arguably a reasonable (and perhaps only) proxy for 'independence of mind'.

The ASX Corporate Governance Council noted that its guidance is intended to provide an indication of areas boards should consider when determining a director's independent status and not to definitively specify situations where independent judgment is impeded (ASX Corporate Governance Council 2007b). For this reason, boards are able to respond on a 'comply or explain' basis in relation to directors' independence.

Andrew Murray (sub. DD112) submitted that the ASX Corporate Governance Council's approach fails to fully address situations where a director is subject to the patronage of dominant shareholders or individuals. This is akin to APRA's approach, where a direct association with a substantial shareholder of the company would mean the director could not be deemed independent. However, the Australian Securities Exchange (sub. DD142) noted that the important concept in relation to executive remuneration decisions is 'independence of management' and that this is a less restrictive concept than that necessary in other contexts, where independence from substantial shareholders may also be relevant.

In essence, when moving from a 'comply or explain' basis to 'black letter' law, complex definitional issues emerge. In this context, it becomes increasingly problematic to consider differing definitions of independence: for example, where 'independence from management' is applied for remuneration committee membership and a broader definition incorporating independence from major shareholders is used for the audit committee.

Current requirements

To ensure that the board exercises independent judgment, the ASX Corporate Governance Council (2007a) recommends that:

- a majority of the board be independent directors
- the chair of the board be an independent director
- the chair and chief executive officer not be the same individual

- directors considered by the board to be independent are identified in the annual report, with reasons why the board considers the director independent, along with any disclosure of relationships that may affect the director's independence.

In addition, APRA's governance standards require that APRA-regulated institutions' boards comprise a majority of independent directors and have independent chairs who have not been the CEO of the regulated institution at any time in the previous three years (APRA 2009e).

Current practice

The 'independence' of boards in Australia compares favourably with other countries. For example, Australia has a much higher proportion of companies that separate the roles of chair and CEO than the United States (box 6.2). In 2008, around 80 per cent of all listed companies in Australia had a separate chair and CEO (ASX 2009a); this proportion increases for larger companies, with 92 per cent of the top 150 Australian companies having a separate chair and CEO (Mercer, sub. 41, p. 8).

Furthermore, on average, Australia also has a higher proportion of NEDs in large companies than the United Kingdom (box 6.2). In 2007-08, across top 300 companies (by market capitalisation), 74 per cent of directors were NEDs, increasing to 80 per cent for top 50 companies (Korn/Ferry International and Egan Associates 2008).

Guerdon Associates (2009b) observed that boards of ASX300 companies became both larger and more independent between 2007 and 2008. ASX300 company boards, on average, comprised just over half independent directors, with larger companies in this sample having a higher proportion of independent directors (figure 6.1).

Thus, the prevalence of a majority of independent directors on boards decreases the smaller the company. In 2008, only 45 per cent of all listed companies indicated that their boards comprised a majority of independent NEDs (ASX 2009a). Generally, companies that did not have a majority of independent NEDs reported that this was due to their relatively small size, lack of resources or that the experience and skills of non-independent directors were appropriate.

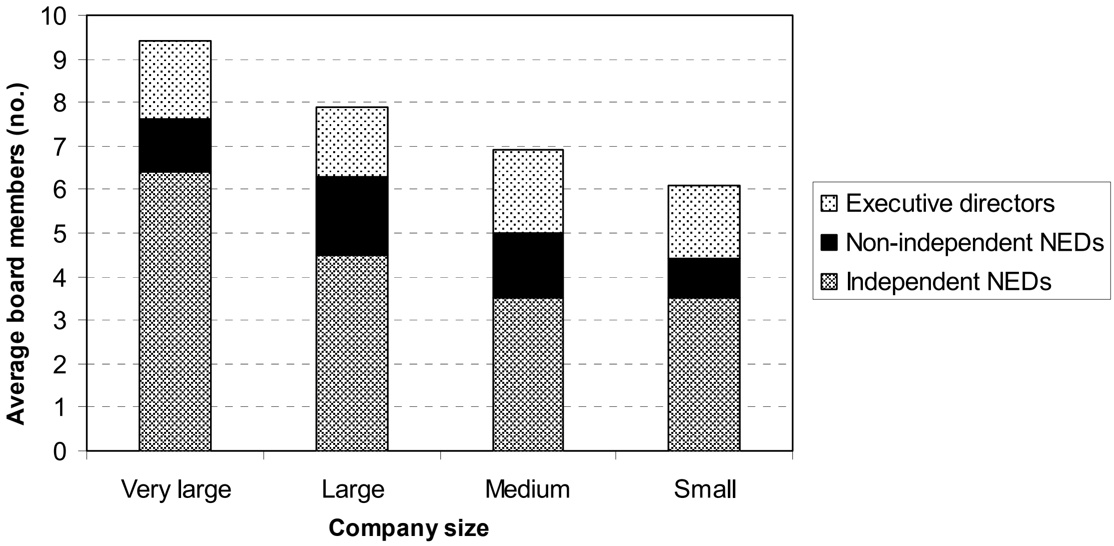
Box 6.2 **International regulation and practice on board structure**

In the United States, the practice of combining the role of CEO and chair is common, and is the case for almost three-quarters of top 200 companies in 2008 (NACD 2009).

In the United Kingdom, the Combined Code states there should be a strong presence of both executive and NEDs on the board, with at least half the board being independent directors. PricewaterhouseCoopers (2008) suggests that the boards of larger UK companies comprise about 60 per cent NEDs.

Some European companies, such as in France, the Netherlands and Germany, adopt a 'dual board' structure involving a 'managing' board, comprising executive directors and a separate 'supervisory' board, consisting of NEDs.

Figure 6.1 **Board structure by company size[a], ASX300 companies, 2007–08**



[a] Company size determined using market capitalisation and sample split into quartiles. 'Very large' equates to market capitalisation over $2 billion; 'Large' equates to between $650 million and $2 billion; 'Medium' equates to between $240 million and $650 million; and 'Small' equates to less than $240 million.

Source: Guerdon Associates (2009b).

Balancing inside knowledge and independence

Executive directors are able to bring company-specific knowledge to board deliberations and their presence can enhance board effectiveness and company performance. This may also apply to NEDs who cannot be regarded as fully independent — for example, if they were previously employed by the company.

However, the presence of executive directors on a board also poses challenges. Because they hold senior managerial positions within the company, executive directors may be too close to management to perform impartial monitoring. This could also apply for non-independent NEDs. However, on the whole, representation of executive directors, and non-independent NEDs on Australian boards, is relatively low. Figure 6.1 indicates that, irrespective of board size, there are on average two executive directors on ASX300 company boards and one to two NEDs who are not 'independent'.

It is not always appropriate for a company to have a majority of independent directors on its board (box 6.3). In a small start-up company, for example, company-specific expertise may be a more valuable attribute than independent monitoring and advisory skills. However, in a larger, more mature company, a majority of independent directors on the board may be more appropriate, as the costs arising from insufficient monitoring and undesirable actions are likely to be much greater.

The heterogeneity of companies suggests that different tradeoffs will be made between the monitoring and advisory skills provided by independent directors and the company expertise afforded by executive (and possibly other non-independent) directors.

Similarly, from the perspective of enhancing company performance, it may not always be best to separate the role of chair and CEO. Separation may be less suited to highly entrepreneurial companies (likely to be small), where the equity market may view a dual CEO/chair as positive. Furthermore, if CEO/chairs have a major equity stake in the company, they are likely to pursue actions that are in its best interests. In this way, equity ownership and separation of the roles of CEO and chair may, to a certain extent, be substitutes in promoting desirable managerial actions. However, this is only likely to occur in exceptional circumstances in closely held companies. From the perspective of promoting good corporate governance, separation of the CEO and chair generally remains a desirable principle.

Box 6.3 **Board independence and company performance**

While it is commonly held that increasing the proportion of independent directors on a board will improve company performance, the evidence from academic research is equivocal.

Bhagat and Black (2002) assess whether greater board independence is correlated with long-term company performance. Analysing a sample of US companies over the 1980s and 1990s, they find that there is a *negative* correlation between recent company performance and board independence. They interpret this as providing evidence that poorly performing companies increase the share of independent directors on their board in an attempt to improve performance. However, they do not find that this actually improves subsequent company performance.

In Australia, similar research has also yielded conflicting results. For example, Lawrence and Stapledon (1999), using a sample of the top 100 companies (by market capitalisation) in 1995, found no strong evidence that the share of independent directors on a company board affects share price returns or accounting performance. On the implications for policy, they note that:

> Each additional regulatory requirement imposed on companies adds to the compliance costs for those companies (and, indirectly, their shareholders). Therefore, even if the empirical evidence unequivocally indicated that board structure and composition improved corporate performance, it would still be necessary to ask whether the costs of imposing governance regulations on all listed companies would be outweighed by the benefits. (Lawrence and Stapledon 1999, p. 57)

In an analysis of the board characteristics of 348 of the ASX500 companies in 1996, Kiel and Nicholson (2003) find a negative relationship between Tobin's Q (a ratio comparing the market value of a company's stock with the value of a company's assets) and the proportion of outside directors serving on the company board. The authors concluded that, although boards do need to be aware of possible agency problems, no single theory provides a complete explanation of the relationship between corporate governance and corporate performance (Kiel and Nicholson 2003, p. 201).

6.2 Attracting talented and experienced candidates

It is important that Australian boards are able to attract a wide range of talented and experienced individuals to serve as company directors. However, some participants questioned whether this is happening in practice. In particular, participants raised concerns regarding nomination committee processes and whether boards are fully exploring the pool of potential candidates for directorships.

Current practice

Directors are appointed by resolution at a general meeting of the company, with the board and its chair playing an important role in the nomination of candidates. When a seat on the board becomes vacant, it is usual practice for directors to appoint someone to this role, pending approval by shareholders at the company's next annual general meeting (CAMAC 2009).

The ASX Corporate Governance Council (2007a) recommends that boards have a nomination committee, and suggests that the committee comprise predominantly independent directors and an independent chair. They also suggest that the nomination committee make recommendations about necessary competencies of directors, board succession plans, processes for evaluation of board performance and the appointment and re-election of directors. The Council notes, however, that for smaller boards such a committee may not be practical.

Around half of top 400 companies by market capitalisation reported they had a separately constituted nomination committee in 2008 (table 6.1). For mid-cap companies (those ranked 251–400 by market capitalisation), where nomination committees existed, independent representation was not high. For example, 47 per cent of reported nomination committees did not comprise a majority of independent members. Larger companies that had a nomination committee were more likely to have a majority of independent members and an independent chair (WHK Horwath 2009a, 2009b).

The Corporations Act and a company's constitution outline the ways in which a director can leave office. These include resigning, breaching provisions in the company's constitution, being automatically disqualified from managing a corporation, becoming bankrupt or being removed by resolution in a general meeting (AICD 2007b). Only shareholders appoint and remove directors of public companies.

The ASX listing rules specify that directors can hold office for no more than three years without re-election. The average tenure of NEDs from ASX100 companies in 2007 was around five years (and nearly seven years for executive directors) (ACSI 2008b). However, over one-third of all directors on ASX100 company boards had served for over nine years.

Table 6.1 **Nomination committees in top 400 companies in 2008 annual reports**

	Top 250 companies	*Companies ranked 251–400*
	% all companies	% all companies
Nomination committee	59	47
Independence[a] of nomination committee:	% companies with nomination committee	% companies with nomination committee
• Independent chair	83	76
• Only independent members	36	18
• Majority independent members	44	35
• No majority independent members	20	47

[a] WHK Horwath define an independent director as someone who is not a member of management and who: (1) is not, or is not associated with, a substantial shareholder; (2) has not been employed in an executive capacity by the company in the last decade; (3) is not an original founder of the company; (4) is not a professional adviser to the company or is not a principal of a professional adviser to the company; (5) is not, or is not associated with, a significant supplier or customer; (6) has no significant contractual relationship with the company; (7) is free from any interest or relationship, that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; and (8) has been a director for ten years or less.

Sources: WHK Horwath (2009a, 2009b).

Are boards 'clubby'?

Some participants suggested that representation on boards across Australia effectively involves a 'directors club', recruiting among itself or from the ranks of known executives. In particular, concerns were raised about the role that incumbent board members play in influencing the ability of new entrants to gain seats on boards (box 6.4).

Box 6.4 **A 'director's club'? — views from submissions**

The Australian Council of Super Investors stated 'we also note there's a perception of clubbiness of boards, particularly given the propensity of boards to recruit from their ranks' (trans., p. 301).

The Australian Human Resources Institute noted that directorships should not be determined by 'a club operating in accordance with an informal and discriminatory entry system where chaps look after chaps' (sub. 49, attachment 3, p. 3).

Amongst other reasons, the Australian Shareholders' Association cited the concentration of directors on boards as a reason for high executive pay:

> It is the view of the ASA that there is currently an imbalance in favour of executives when setting remuneration. The causes include … The concentration and lack of diversity of non-executive directors. (sub. 54, p. 20)

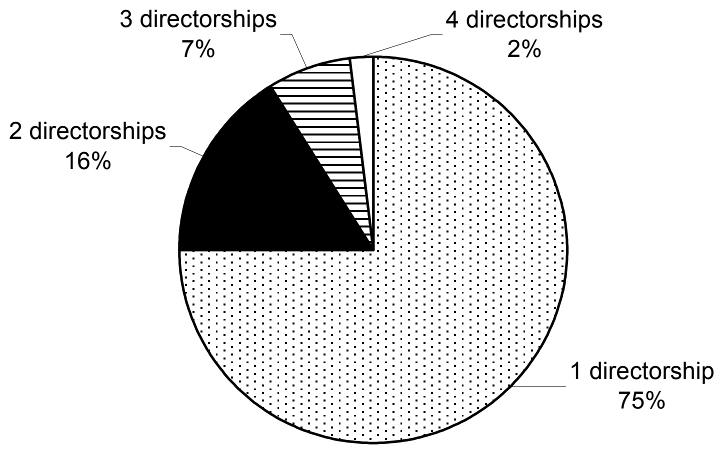
Perceptions of a ‘director’s club’, and a lack of diversity in board membership, was seen as limiting the scope to access talented and experienced individuals and resulting in directors spreading themselves too thinly across multiple appointments, as well as affecting the exercise of ‘independent’ judgment.

A key indicator of whether boards are ‘clubby’ is the extent to which directors hold multiple directorships. Evidence from Australian Council of Super Investors (ACSI) (2008b) indicates that in 2006-07, among ASX100 companies:

- of 106 new NEDs, 55 per cent already held, or once held, an ASX100 director position
- three-quarters of all NEDs in these companies sat on only one board (representing 56 per cent of all NED board seats), with 9 per cent holding three or four directorships on ASX100 boards (representing 17 per cent of all NED ASX100 company board seats) (figure 6.2).

Unsurprisingly, the incidence of executive directors holding multiple directorships is much lower than that for NEDs. Only 8.5 per cent of ASX100 company executive directors also held an additional non-executive directorship in an ASX100 company, with none holding two or more such executive directorships (ACSI 2008b).

Figure 6.2 **Percentage of NEDs in ASX100 companies by number of ASX100 board seats held, 2006-07**



Sources: ACSI (2008b); RiskMetrics (pers. comm., 10 September 2009).

This suggests that multiple directorships among the boards of ASX100 companies are not widespread. However, many directors hold more than one directorship across a range of publicly-listed, private and not-for-profit companies. To illustrate the number and type of directorships held by NEDs, a brief profile of the directors of boards of three large Australian companies is provided (box 6.5).

Further, when all listed companies are considered, multiple directorships appear more common (table 6.2). However, some instances of high multiple directorships might be explained by corporate groups, where a director may sit on the boards of a number of companies within the group (for example, listed property trusts linked to a single company) (Kiel and Nicholson 2006).

Box 6.5 **Non-executive directors at three large public companies**

In 2008, **BHP Billiton** had a total of eleven NEDs and one executive on its board of directors. Only one of these directors held another directorship in an ASX100 company (of which he held two). No other BHP Billiton directors sat on ASX300 company boards, although several directors sat on boards of foreign or private companies. There was one female on the BHP Billiton board (BHP Billiton 2008).

National Australia Bank had a total of eight NEDs and two executives on its board. Three NEDs held one other directorship in an ASX100 company and two NEDs held two other directorships in ASX100 companies. One NED had four directorships in total in ASX300 companies (including with the National Australia Bank). Many of these directors also held directorships in private companies. There were two female directors on the board (National Australia Bank 2008).

In 2008, **Wesfarmers** had seven NEDs and two executive directors on its board. Of Wesfarmers' seven NEDs, two held two directorships in other ASX100 companies and two held one directorship in another ASX100 company. One of these NEDs held a total of four directorships in ASX300 companies (including Wesfarmers). Many of these directors also held directorships in private companies or not-for-profits. There was one female NED on the Wesfarmers board. This particular director also served on the National Australia Bank board of directors (Wesfarmers 2008).

To prevent any 'over-boarding', some participants suggested that regulatory limits on multiple directorships be imposed. For example, the Australian Shareholders' Association considered that NEDs should hold no more than five directorships (where a chair counts as two) (ASA 2005). However, figure 6.2 and table 6.2 indicate that only a small percentage of ASX100 directors would not pass this test, when considering only ASX100 companies, even when taking into account the greater working requirements for a chair and thus allocating double 'points' for such a role. However, this may change where a broader range of companies and organisations are considered.

Table 6.2 **Number of directorships in all listed companies held by directors in ASX100 companies, 2006-07**

Number of directorships	*Number of directors*	*Proportion of all directors*
	no.	%
1	333	55.8
2	129	21.6
3	76	12.7
4	43	7.2
5	10	1.7
6	3	0.5
7	2	0.3
8	1	0.2
Total	**597**	**100.0**

Source: ACSI (2008b).

There are some benefits as well as problems with ‘clubs’, particularly in a corporate context where board performance is crucially linked to directors working well together. For example, limiting entry to candidates known to share certain desired characteristics can reduce the risk of a recruit destabilising the board. Further, the experience from holding multiple directorships can be valuable to the companies concerned. According to Kiel and Nicholson (2006) such directors can use their networks to obtain support from key external stakeholders (resulting in say, access to capital at more attractive rates), can assist in disseminating innovation (including better corporate governance practice), and, particularly for new companies, can enhance reputation or credibility in the market.

However, there are concerns that as a result of their experiences and networks, members of the club may identify too closely with executives in deliberations about executive pay. One submission noted that:

> … the problem with this is the perception of a self-interested ‘directors club’ of board members, fund managers, and executives past and present. ‘You vote for my pay rise and I’ll vote for yours’. This is an inherently conflicted plutocracy. (Michael Vanderlaan, sub. 9, p. 2).

Although restricting multiple directorships could increase the range of directors serving on boards, it might also prevent quality candidates who would be a better ‘fit’ from being chosen, and result in a loss of benefits that leveraging on a director’s experience and networks can provide. The point at which ‘over-boarding’ becomes problematic may be best left to boards, individual directors who face positional liability consequences from poor decision making and shareholders. As ultimately they vote on directors, it is incumbent on shareholders to assess the merits of each director, including their past and current roles, when voting on candidates.

A lack of diversity?

A related concern is the lack of diversity among those who sit on boards, and, in particular, the significant under-representation of women. This raises questions regarding the comprehensiveness of nomination processes and whether boards are endorsing individuals who will most effectively represent shareholders.

Jillian Segal (sub. DD167) noted that seeking 'board diversity' is about seeking diversity of thought that results from diversity of background and experience, which can lead to improved decision making. Therefore, diversity can include observable and readily detectable attributes such as ethnic background, gender and age and also less visible underlying attributes such as education and personal views (Milliken and Martins 1996).

While the research is mixed on the impact of diversity on board and company performance (box 6.6), there is evidence that more diverse groups can foster creativity and be open to a greater range of perspectives (Milliken and Martins 1996; Anderson et al. 2009). However studies have also found that diversity in teams can lead to reduced integration of group members and higher levels of dissatisfaction and turnover (Lau and Murnighan 1998 and O'Reilly et al. 1989).

Box 6.6 **What is the impact of diversity on boards?**

Studies have shown that diverse boards can improve monitoring (of other board members and of the company) and can positively affect company performance for more complex companies or where CEO power is strong (Adams and Ferreira 2009; Anderson et al. 2009). Research has also shown that shareholders place a premium on more diverse boards (Westphal and Zajac 1995).

However, diversity is a 'double-edged sword' (Milliken and Martins 1996) and can have costs including reduced cohesiveness, communication breakdown or factions (Lau and Murnighan 1998; O'Reilly et al. 1989).

A number of participants regarded the lack of diversity as an important issue (Chartered Secretaries Australia, sub. DD147; Freehills, sub. DD130). The Australian Human Resources Institute (AHRI) argued that boards:

> … have not kept in step with the rest of society, and on the evidence available, are most unlikely to do so of their own volition, which is to the potential detriment of both the community and shareholders. (sub. DD114, p. 3)

In particular, participants focussed on the lack of gender balance on boards (ACTU, sub. 82; AHRI, sub. DD114; Jillian Segal, sub. DD167). ACSI observed that:

> There is a strong perception that females have to jump through a higher skills 'hoop' than their male counterparts in order to grab the attention of prospective boards. There are situations that arise where boards look for new talent and the specificity of the skills required may potentially exclude female candidates. (sub. DD156, p. 4)

Guerdon Associates stated that 'the low board representation of women indicates that current board demographics are not representative of the broader community, or even the executive community' (sub. DD119, p 3).

The Business Council of Australia (BCA) noted that 'the evidence does show that diversity in decision-making leads to better decisions' (BCA, DD trans., p. 221) and welcomed a broadening of discussion on board diversity beyond issues of gender. Jillian Segal (sub. DD167) argued that an initial focus on improving gender diversity is the first and most important step in improving the diversity of the talent pool from which future directors can be drawn.

While the Commission obviously accepts that the diversity issue extends beyond gender, gender is a visible indicator and perhaps the most pervasive one. The fact that the representation of women on boards is so low strongly suggests that boards are not drawing sufficiently widely from the potential talent pool.

The gender imbalance

A recent study by the Corporations and Markets Advisory Committee (CAMAC) examined the diversity of corporate board membership in Australia, noting a significant gender imbalance (CAMAC 2009). Research by the Equal Opportunity in the Workplace Agency indicates that female representation on Australian boards in 2008 fell below 2006 levels (table 6.3). Just over one-half of ASX200 companies do not have a woman on the board (EOWA 2008).

As table 6.3 shows, there is a similar imbalance in representation of women in executive management roles. A slightly higher proportion of women are reported as holding 'executive management' roles, with little increase in this proportion over the past six years. The Sex Discrimination Commissioner argued that this trend is likely to continue, with 5.9 per cent of women in executive 'in line' management positions in 2008 (down from 7.5 per cent in 2006) (Australian Human Rights Commission 2009).

There are some indications that it is common for non-executive directorship candidates to be sourced from the ranks of senior executive management; for example, in 2000, 35 per cent of NEDs were retired CEOs (Sheridan 2001). In 2006, ACSI reported that 50 per cent of ASX200 NEDs comprised retired former corporate executives (ACSI 2007). Thus, since the 'feeder group' for board positions is likely to be dominated by people with senior management experience, the comparably low proportion of women on boards mirrors a wider phenomenon.

Table 6.3 **Representation of women on boards and in executive management, ASX200 companies, 2002–08**

Year	*Board seats held by women as a proportion of all directorships*	*Female executives as a proportion of all executive positions*
	%	%
2002	8.2	8.4
2004	8.2	11.4
2006	8.7	12.0
2008	8.3	10.7

Sources: EOWA (2002a, 2002b, 2008).

Improving female representation on boards

Quotas and 'soft targets'

It might be expected that heightened competitive market pressures would mitigate against (and significantly increase the costs of) boards not fully exploiting the pool of potential candidates for directorships. However, the significant under-representation of women on boards belies this. In the context of recent statistics indicating that the gender diversity of boards has actually worsened, some participants argued that a significant change in policy approach — or 'circuit breaker' — was required. Their views reflected elevation of the issue evident in the community more widely (box 6.7).

Measures commonly advocated to increase the representation of women on corporate boards are quotas and targets. These could be mandated or applied on a voluntary basis, or through some combination of the two. Recently, the Sex Discrimination Commissioner proposed that publicly listed companies be required to set three and five year targets for gender equality on company boards and at senior leadership levels, and to publicly report on progress in their annual reports (box 6.7 and Broderick 2009).

Box 6.7 **Getting more women 'on board'**

Over recent months, there has been a more elevated public debate about the obstacles to female representation on the boards of Australian public companies. Two opinion pieces that have appeared in the Australian Financial Review are illustrative.

According to Claire Braund (Executive Director of Women on Boards), in her article 'Women Losing the Board Game':

> If the board is responsible for hiring the chief executive, influencing the appointment and setting the strategic direction for the company, why has attention not been paid to the deficit of women in top ranks and the serious economic implications of this human capital loss over the past two decades? What has been the role of advisers such as executive search firms in alerting boards to the need to look beyond traditional sources (former CEO and male partners) to serve as board members?
>
> … At the 2nd Diversity on Boards Conference, two stories emerged that highlight different approaches to improving opportunities for women at senior levels. The first was told by the 40-something chairman of a large Australian engineering and construction firm, who noticed that no women were participating in his company's leadership program. When he asked why, he was told women were not applying as they felt there was little point in such a male-dominated organisation. The result — the chairman and his board set a target for gender participation in the leadership program and women are now visible.
>
> The second story was told by five Women on Boards members (including a former CEO) about their application for a vacancy for a well-paid board gig in a mid-sized company. None could believe she had not even been spoken to by the recruitment firm handling the appointment. But one told how she had emailed the chair, a former colleague who had said she would be great for the role. When she received the rejection notice, she forwarded it to the chair. The result — the chair ensured she was placed on the shortlist and, in time, appointed to the board as the best candidate. (Braund 2009)

Elizabeth Broderick (Sex Discrimination Commissioner), in her article 'Make Room at the Table for Women' also expressed concern about the productivity impacts of ignoring talented women and argued for targets or quotas to remedy the deficit:

> … the 2009 Global Gender Gap report reveals that … Australia sits in a group of countries that are number one in the world for women's educational attainment. But, in terms of women's labour market participation, we have dropped 10 rankings … We are now ranked 50th in the world …
>
> Let's be clear about the low female participation rates, the absence of women on boards and in senior levels of endeavour across the country. It is just not smart. There is no nation or government, industry or sector which can afford this kind of loss. I keep saying that without significant intervention — by government, by business — the number of women participating and progressing in the workplace will shrink even more and our ability to build the strong economy we want will be severely diminished.
>
> It has become imperative that we implement special measures to accelerate the progression of women. It is becoming clearer and clearer that if we are to secure increased participation by women, it will be necessary to set numerical goals such as targets and quotas … Publicly listed companies should set their own three and five year gender diversity targets at both Board and executive level … If there is no significant progress over the next five years, then the Government may find that it has no other choice than to consider the imposition of quotas. (Broderick 2009)

Some countries have introduced quotas mandated in legislation for gender representation on corporate boards. Norway recently introduced a gender quota for all publicly listed companies, requiring that women make up at least 40 per cent of the membership of company boards (box 6.8). Spain also enacted legislation requiring female representation on boards for any company tendering for public contracts. Further, Spain has introduced legislation, to come into effect in 2015, which follows Norway's approach. Media reports indicate that the French parliament is also considering a bill (submitted in December 2009) to require all companies listed on the Paris stock exchange to ensure 50 per cent representation of women on their boards by 2015 (Davies 2009).

Box 6.8 **Norway's quota for female directors of public companies**

In December 2003, Norway enacted legislation imposing a quota of 40 per cent females on boards of public sector entities. At the same time, the government announced that quotas would also be applied to private companies if improved gender representation was not achieved voluntarily by July 2005. Due to insufficient progress in meeting voluntary targets, the law was extended to all new public limited liability companies in 2006 and to public limited liability companies incorporated prior to 2006 from 2008 (Norwegian Ministry of Children and Equality 2009). Penalties for non-compliance with this law include de-listing or even liquidation.

There are around 500 public limited liability companies registered in Norway, incorporating some of the largest companies in oil, manufacturing and financial sectors (Nergaard 2008). In January 2008, 93 per cent of Norway's public limited liability companies complied with the legislation (Norwegian Ministry of Children and Equality 2009) and by January 2009 female representation on public limited liability company boards was 40.2 per cent (Statistics Norway 2009).

CAMAC highlighted several problems with the Norwegian approach, noting that 'it appears that PLCs [public limited liability companies] have encountered difficulty in finding a sufficient number of women with requisite experience or knowledge of the relevant industry for board appointment' and that this has resulted in significant multiple directorships by some women (CAMAC 2009, p. 48). While there is some evidence that the Norwegian quota may have imposed costs on firms' performance, it is too soon to determine the extent of this. Several 'supply-side' programs have subsequently been introduced and recent data from Statistics Norway suggests that multiple directorships by women are not greater than for men (Statistics Norway 2009).

Victoria, South Australia and the ACT have set voluntary targets to achieve greater representation of women on state government boards. In the case of South Australia, the target was 50 per cent female representation by 2008 and 50 per cent representation of female chairs by 2012 on state government boards and committees. In 2009, South Australia was still short of its first target, with

45 per cent female representation, while 35 per cent of chairs on state government boards were female (Government of South Australia 2009).

In its report on board diversity, CAMAC noted that voluntary targets may be a useful tool for a company. However, it did not support the imposition of ‘a particular model of board diversity’ through gender or other quotas (CAMAC 2009, p. 48). In reference to quotas for boards of government bodies, CAMAC noted that there is a fundamental difference between public sector and private sector entities — with the government, in effect, being the sole shareholder in the first case. By imposing quotas on private entities the government would ‘cut across the powers of shareholders to choose the directors who will be accountable to them’ (CAMAC 2009, p. 49).

The Commission acknowledges that ultimately a company’s shareholders should determine who sits on the board, but this choice is inherently influenced by the board and its nomination processes. While shareholders may nominate their own representatives, it is the board that has the resources and the mandate to select nominees from a pool of candidates, as well as more detailed knowledge about the skill-sets needed by the company. Encouraging boards to seek qualified female candidates and put forward more women for nomination would not impinge on shareholders’ abilities to vote against these candidates where they do not consider them suitable.

One lesson that appears to have emerged from the Norwegian experience is that any efforts to improve representation of women on boards must take into account the supply-side or ‘pipeline’. Although the educational levels for women are high in Australia (for example, in 2007 women accounted for 56 per cent of all higher education students (DEEWR 2008)), many women are not getting crucial executive experience. This poses a dilemma for boards attempting to identify potential female directors. Research by Catalyst (2008) indicates a clear positive correlation between the proportion of women board directors in the past and the proportion of women corporate officers in the future. This could be because companies with women on their boards tend to have more inclusive workplace cultures and policies that support women’s advancement. Further, women board directors can be role models and mentors to women in the ‘pipeline’. This suggests scope for measures that address gender diversity at the board level to lead to improvements in the ‘supply-side’ within companies.

Some research indicates that only one woman on a board may not be sufficient to enhance capabilities and drive cultural change (Chief Executive Women 2009). In an informal roundtable held by the Commission, participants agreed that more than one woman on a board was required to move beyond tokenism. It was noted that when there is only one woman on a board, her perspective and views might not be afforded equal weight, and that attainment of a critical mass was required for effective change to occur.

However, historically there has been significant ‘push-back’ on gender quotas, chiefly as they are seen as undermining women’s professionalism and credibility and implying that their selection is not based solely on merit. Moreover, the imposition of mandatory quotas could prevent candidates who would be a better ‘fit’ from being chosen, leading to less experienced boards and negative impacts on company performance. While there is evidence that increased representation of women on boards can be good for the bottom line, it is not clear that this would be the case for all companies at all times and not under externally-imposed timeframes (box 6.9).

Box 6.9 **Does female representation matter?**

A range of reports find a positive relationship between company performance and the representation of women on boards (Catalyst 2007; Desvaux et al. 2008). One complication is the direction of causality — is positive performance due to more women on boards or are successful companies more likely to have more diverse boards? Smith et al. (2005) address the issue of causality and still find a positive relationship between company performance and female representation on boards in Danish companies. However, Adams and Ferreira (2009) found that the impact on board performance of gender diversity is likely to be positive for some companies and negative for others. Anderson et al. (2009) find that company performance is more sensitive to occupational diversity than social diversity (gender, ethnicity and age).

There is evidence to suggest that women directors are more likely to be independent from management and as such improve board monitoring capabilities. However, Adams and Ferreira (2009) find that a focus on monitoring at the expense of other strategic issues can be detrimental for some companies.

Many studies find little correlation between the representation of women on boards and CEO pay (Kaplan et al. 2008; Doucougliagos et al. 2007). However, Adams and Ferreira (2009) found CEO turnover is more sensitive to stock performance and that directors receive more equity-based remuneration in companies with gender diverse boards.

In reference to Norway’s quotas for corporate boards, ACSI noted that:

> They say it’s worked extremely well but Norway has a very different culture I think about all sorts of matters to ours, and whether such a proposition would be acceptable here, we doubt, so we're not at present advocating quota systems. But certainly there is need for some kind of a circuit-breaker. (DD trans., p. 235)

While there was general resistance among participants to externally imposed quotas, there was considerable support for 'soft' or voluntary targets to improve the representation of women on Australian boards. ACSI submitted that 'voluntary targets endorsed by boards may promote more concrete objectives with respect to skills and diversity without being perceived to be addressing these issues in a tokenistic manner' (sub. DD156, p. 4). Jillian Segal (sub. DD167) proposed that all listed companies develop targets for female board representation and report against these on an 'if not, why not' basis. She suggested that targets could be determined by companies taking into account their own particular circumstances or could be benchmarked against a longer term goal of achieving, for example, 40 per cent representation within five years.

The AICD — while noting that companies should set measurable milestones towards achieving diversity goals — argued that any such goals and timeframes should be determined by individual companies according to their own circumstances and not be imposed by government, the ASX, or any other body, on a 'one size fits all' basis (AICD 2009a, box 6.10).

In a significant recent initiative, the ASX Corporate Governance Council announced proposals to expand the Corporate Governance Principles and Recommendations to recommend that each listed entity establish and disclose a diversity policy with measurable objectives relating to gender, and disclose in the annual report achievements against the gender objectives set out in the policy — on an 'if not, why not' basis (ASX 2009g).

The Commission considers that the introduction of targets, determined by companies according to their particular circumstances and reported on an 'if not, why not' basis, would encourage greater board diversity, but in a way that promoted company performance and had few downside risks. Such an approach would ideally be complemented by a range of supply-side approaches, potentially industry-led, both to ensure that there were appropriately qualified candidates and that their existence was brought to boards' attention in an effective way.

Box 6.10 **AICD measures to improve diversity on boards**

In November 2009 the AICD introduced a range of measures to achieve a greater representation of women on boards and in senior executive positions. These measures include:

- recommendations for boards to voluntarily adopt, and report on, diversity policies and goals for the board and senior management
- recommendations for comprehensive board reporting to shareholders on board selection and nomination processes
- the establishment of a mentoring program involving mentors from senior listed company chairmen to work with senior executive and professional women
- providing new guidance for boards and search professionals for a structured selection process for board appointments that highlights the advantages of diversity
- enhancing AICDs database and information services for current and aspiring women directors
- advocating that boards develop explicit policies to enhance the career development and retention of women in management roles in the company, this would include 'family-friendly' staffing practices and flexible working arrangements
- establishing an AICD scholarship program and other educational initiatives.

Source: AICD (2009a).

Improved disclosure of nomination processes and diversity policies and objectives

Some participants suggested that one way to enhance board diversity would be to place a greater emphasis on the board nomination process (Guerdon Associates, sub. DD119; Origin, sub. DD129; Perpetual, sub. DD128; UniSuper, sub. DD118). Guerdon Associates noted that 'this 'sleepy hollow' of board function is arguably one of the most important' (sub. DD119, p. 4) while UniSuper (sub. DD118) argued that the functions of the nomination committee should be raised to a level of importance equal to the remuneration committee.

Currently — under recommendation 2.6 — the ASX Corporate Governance Council suggests the following information be made publicly available:

- a description of the procedure for the selection and appointment of new directors and the re-election of incumbent directors
- the charter of the nomination committee or a summary of the role, rights, responsibilities and membership requirements for that committee

- the board's policy for the nomination and appointment of directors.

Perpetual (sub. DD128) recommended a greater focus on nomination committees in respect to:

- utilising external recruitment consultants to undertake searches based on skills and experience required on the board
- promoting a greater focus on the processes involved in board nominations
- raising standards to ensure that board accountability begins with the process of board nomination (p. 2).

Regnan suggested that the board prepare a report explaining the board's nomination processes, required skill set, board education, board induction processes and policies which allow directors access to expert advice. This report would then be subject to a non-binding vote by shareholders in order to increase shareholder oversight of board composition (sub. DD169).

The Commission considers that the current ASX Corporate Governance Council's guidance in relation to nomination committees and disclosure of nomination committee function is appropriate and that a greater focus on the nomination process could be accommodated within the current guidance.

There was also support from participants for enhanced reporting on company and board diversity objectives (AHRI, sub. DD114 and AICD, see box 6.10). AHRI recommended that leading ASX companies include statements within their Annual Report or Sustainability Reports as to their policies, targets and practices with respect to diversity at a whole-of-company level (that is, including management and board levels). The AICD was also supportive of such approaches and recommended that boards voluntarily adopt, and report on, diversity policies and goals for the board and senior management (box 6.10).

In its report on the diversity of boards, CAMAC made three proposals for changes to the ASX Corporate Governance Council's commentary on board composition and effectiveness:

- the commentary could include references to board diversity and ways to achieve diversity goals
- the commentary could refer to the benefits of undertaking a structured approach to board nominations
- recommending that companies provide further information to shareholders on the board recruitment process.

After considering CAMAC's recommendations, the ASX Corporate Governance Council has recently proposed changes to its governance standards, including recommendations that companies:

- establish a diversity policy
- disclose in the annual report the proportion of women employees in the organisation, in senior management and on the board
- include a requirement to continuously review the proportion of women at all levels of the company in the nomination committee charter
- disclose the skills and diversity criterion boards use when looking for new board appointments (ASX 2009g).

Enhancing scope for board renewal

One possible barrier to more diverse board membership is the entrenchment of incumbent directors. The ASX Corporate Governance Council (2007a) notes that board renewal is critical to performance. However, it is not clear to what extent boards' performance management systems contend with under-performance. This is complicated by the difficulty faced by shareholders in assessing the performance of individual directors. As stated by RiskMetrics to the Parliamentary Joint Committee on Corporations and Financial Services:

> From the outside, it is a very hard thing for an institutional shareholder to work out, for each individual director, the answer to the question, 'Is this individual director a great guy on a board that is a dud?'. (Parliamentary Joint Committee on Corporations and Financial Services 2008, p. 59).

Contestable board seats

AHRI (sub. DD114) recommended that boards hold 'contestable elections' which apply to directors who have served for five years or more, or stand for election for the second or subsequent time. These 'contestable' seats would be open for other nominations from shareholders. In addition, boards could recommend several candidates, including one 'board-endorsed candidate'. The elections could be held on a 'first past the post' basis.

While this would lead to shareholders being able to vote on a wider pool of possible candidates and provide a clear process for shareholders to nominate candidates, some practical difficulties arise. First, uncertainty may be created where the board nominates a number of candidates but only officially 'endorses' one. Further, due to reputational risks associated with not being elected, potential applicants may be unwilling to subject themselves to such a poll, particularly where they are the non-endorsed 'additional' candidates put forward by the board.

The 'no vacancy' rule

A potential impediment to the election of new directors is the so-called 'no vacancy' rule. This is based on a common clause in company constitutions that provides for boards to specify the maximum number of directors at any given time, within the limit set by the constitution. Some participants argued that this rule can be used to inhibit shareholders from successfully electing new directors from outside the 'club'.

For example, RiskMetrics contended:

> These clauses allow the board in a contested election — typically when a candidate has been nominated by shareholders — to declare that the maximum number of directors is the number of directors presently on the board and, accordingly, there are no vacancies. For the non-board endorsed candidate this means that in order to be elected they must receive not only a majority of the votes cast on their election but also more votes than the board-endorsed candidate seeking election at the same meeting. (sub. 58, p. 13)

Generally in Australia directors are elected by resolution, with shareholders casting a 'yes' or 'no' vote for each director. Where there are limited seats available on the board, the candidates with the highest number of 'yes' votes win the available seats. If there is only one candidate for one seat, a vote above 50 per cent will be sufficient to secure this position.

In an environment where the average (board-endorsed) incumbent typically receives a 96 per cent 'yes' vote (RiskMetrics 2008a) — non-endorsed candidates clearly face significant difficulties. Thus, some participants argued that the 'no vacancy' rule should be removed, allowing shareholders to choose the number of members to sit on the board (Stephen Mayne, trans., p. 236; RiskMetrics 2008a). Such an approach was also supported by Andrew Murray (sub. DD112), AHRI (sub. DD114), the Australian Shareholders' Association (sub. DD121), the Finance Sector Union (sub. DD126), the Law Council of Australia (sub. DD150) and ACSI (sub. DD156).

The 'no vacancy' rule was examined by the Parliamentary Joint Committee on Corporations and Financial Services in 2008. It found that dominance of entrenched directors on company boards is contrary to good governance and shareholder interests. The committee concluded that the process for nominating and electing directors in Australia could be substantially improved in many companies to ensure better quality candidates are appointed to company boards. It recommended that the

Australian Securities and Investments Commission develop a best practice guide to company constitutional recommendations and practices governing the nomination and election of directors (Parliamentary Joint Committee on Corporations and Financial Services 2008).

Providing shareholders with a say on the application of the ‘no vacancy’ rule would mean that boards could no longer arbitrarily determine the maximum number of board members within the range in the constitution. One way of achieving this is to require that boards table a resolution at general meetings in circumstances where they wish to invoke the ‘no vacancy rule’ and non-endorsed candidates have submitted for election. Where this resolution is rejected by shareholders, candidates would be able to run for board vacancies up to the maximum number of seats stipulated in the company constitution. In situations where insufficient candidates receive a majority vote, the board would operate below the limit.

However, a question arises as to whether such a change would in practice make much difference. A significant number of participants considered that removing the ‘no vacancy’ rule would be unlikely to remove barriers to entry for appropriately qualified individuals to contest board elections and would have little impact on board diversity (AICD, sub. DD149; Boral, sub. DD123; Macquarie Group, sub. DD157; Westpac, sub. DD158). First, candidates must achieve a ‘yes’ vote of at least 50 per cent to successfully obtain a vacant seat. Given the importance of board stability and the confidence placed in board members by shareholders, it is highly likely that shareholders will continue to show strong support for board-endorsed candidates.

Second, participants have suggested that where an ‘outside’ candidate was a threat, boards may take pre-emptive action to fill any vacancies. Where this occurs the number of board members would tend over time to gravitate towards the maximum number allowed. If boards become too large this may affect the quality of their performance, while operating at the constitutional maximum would reduce the board’s flexibility to appoint additional directors when suitable candidates become available, and manage succession (AICD, sub. DD149; Australian Bankers’ Association, sub. DD135; BCA, sub. DD152; Boral, sub. DD123; Origin, sub. DD129; Perpetual, sub. DD128; Swan 2009; UniSuper, sub. DD118). Given the costs involved, boards would only take this approach where they considered the risk of a non-endorsed candidate being elected to be both high and detrimental to board performance.

An alternative response may be that the board seeks to reduce the maximum limit in the constitution in order to reduce the costs associated with a large board and minimise the number of non-endorsed candidates that could be elected. Once again, such an approach would have resulting costs in terms of reduced flexibility and is only likely to be pursued where the board considers there to be a real and significant threat of non-endorsed candidates being elected.

Boral (sub. DD123) argued that through voting on, and adopting, the company constitution, shareholders already determine the maximum size of the board. In addition, it was widely held by participants that the board is best placed to determine the most appropriate board size at any given time, within the constraints set by the shareholders in the constitution. In particular, it was argued that it can be beneficial for the size of a company's board to fluctuate from time to time — for example, in order to facilitate a transition of membership.

Nevertheless, it is important that the mechanism that enables shareholders to vote for and against directors works effectively — and is seen to be appropriate by shareholders themselves — as other aspects of the governance framework including remuneration practices, are based on this ultimate sanction. Strengthening the power of shareholders to replace directors who they feel are not effectively engaging with shareholders or responding to significant 'no' votes on remuneration reporting is likely to promote greater board accountability. Therefore, while boards are likely to be better situated to assess optimum operational and compositional requirements depending on the companies specific circumstances, it is important that in carrying out this role they do not inhibit shareholders from electing non-board endorsed candidates.

Supply-side approaches

To attain the qualities required to be an accomplished director requires access to relevant opportunities to hone these skills. Thus, where experience in executive management is a highly valued background for directors, the diversity of those in executive management roles directly affects the diversity of boards. Consequently, when considering options to improve diversity of boards it is important to consider supply-side factors and measures that can enhance the development of relevant skills and experience by a wider range of potential recruits to boards. For example, CAMAC referred to mentoring programs and management practices that could assist more female candidates to emerge for board positions (CAMAC 2009).

The AICD has recently released a range of measures to improve board diversity, with several initiatives aimed at addressing supply-side issues (box 6.10). AHRI (sub. DD114) suggested that retail shareholder groups develop a registry of potential board candidates and work with educational institutions to provide a curriculum on board skills and governance practices.

However, while an essential component of improving the number and range of qualified candidates wishing to hold board positions, it is not clear that supply-side approaches alone will be sufficient to address concerns that boards are not adequately utilising a diverse pool of talent.

Other impediments to attracting suitable board candidates?

The liability risks that directors face under corporate and other laws was also raised as a potential disincentive for qualified candidates to take up directorships (Guerdon Associates, sub. DD119). Directors can be personally liable under a range of laws (chapter 2). Under the Corporations Act, directors responsibilities include the duty to: act in good faith in the best interests of the company (s. 181); act with reasonable care and diligence (s. 180); and prevent insolvent trading (s. 588G). Directors can also be held liable under continuous disclosure laws (s. 674). A breach of any of these provisions can give rise to a civil penalty of up to $200 000 (s. 1317G). The Corporations Act also sets out criminal offences where a director is reckless, or intentionally dishonest and fails to exercise their powers and discharge their duties in good faith and in the best interests of the corporation (s. 184). A director found guilty of a criminal offence under this section can face a penalty of up to $200 000, imprisonment for up to five years or both.

A 2008 survey of around 100 directors of ASX200 companies conducted by Treasury in conjunction with the AICD, suggest that liability laws can have a significant impact on directors' decisions to accept or keep a directorship. Concerns regarding perceived personal liability had resulted in respondents declining an offer of directorship (71 per cent of respondents), retiring from a directorship (76 per cent) and resigning from a directorship (46 per cent) (Treasury 2008).

The Treasury survey found that half the respondents perceived there was a high level of risk that they would be found personally liable for decisions made in good faith by themselves or the board. Furthermore, over two-thirds indicated that on occasion this risk of personal liability had resulted in directors or boards taking an overly cautious approach to business decision-making (Treasury 2008).

In practice, however, it is rare for directors to receive civil penalties. In the decade to 2004, 25 civil penalty applications were issued by the Australian Securities and Investments Commission (Welsh 2004). The majority of civil penalty applications issued related to contraventions of the directors' duty and insolvent trading provisions. While the penalty regime enables a criminal prosecution to be instigated after a civil penalty action has been issued, this has only occurred in one case (Welsh 2004). Thus, while it appears that perception regarding liability laws can increase directors' risk aversion, the extent to which this is limiting the pool of quality directors is unclear.

The Australian Government requested the Ministerial Council on Corporations to review director liabilities and identify areas for reform of personal criminal liability for corporate fault, in areas other than occupational health and safety and environmental protection legislation, by mid-2009. This review is still underway (Emerson 2009).

Guerdon Associates observed:

> … COAG is certainly looking at that issue but they appear to be dragging their feet and if that's resolved, at least all the states are bringing their laws into line. They all have laws addressing safety, for example, that impact on directors. Instead of having seven different sets of laws and liabilities, bringing it all into one set would certainly help the process. (DD trans., p. 86)

Recently, the Minister for Employment and Workplace Relations announced that the Workplace Relations Ministerial Council had agreed on a model Occupational Health and Safety Act to be enacted by all States and Territories (apart from Western Australia). These acts will replace the ten principal occupational health and safety statutes across Australia and over 400 regulations and codes of practice (Gillard 2009). These changes should not only reduce compliance costs for many public companies, but also reduce the potential liability of directors in some jurisdictions (notably New South Wales). Progress by COAG in implementing these and other reforms in the 27 'regulatory hotspot' areas should help alleviate disincentives for directors as well as reducing the time required for compliance issues.

Compulsory training for directors

Some participants raised concerns regarding the capabilities of directors on Australian boards. For example, an AHRI member survey indicated that 73 per cent of respondents believe that members of boards often have difficulty understanding the technical complexity of advice they are given on executive remuneration (AHRI 2009, p. 12). The Institute proposed that directors be subject to compulsory education and regular independent assessment of competence in order to ensure that board members possess the appropriate knowledge and experience, with a licence to practice required for directors of large listed companies (sub. 49).

Performance management of directors is the responsibility of the board. The ASX Corporate Governance Council suggests that the nomination committee, where established, should develop and manage the board's performance management system and should ensure appropriate policies are in place to identify, assess and enhance director competencies (ASX Corporate Governance Council 2007a). Within this framework it is not clear that there is a need for independent assessment of director competence.

Board members should have a combination of relevant knowledge, business acumen, interpersonal skills, experience, good judgment, an interest in the business of the company and a commitment to apply themselves to the tasks of the board (CAMAC 2009). Increases in corporate governance regulation and compliance obligations faced by the board may lead to greater weight being placed on particular professional or business backgrounds, as may the nature of a company's operations. Thus, the skills required of a director will vary depending on the nature of the business and the mix of skills and experiences already represented on the board by other members. In addition, it would be very difficult to teach some of these skills through a course.

Currently, directors have access to various courses, such as those run by the AICD and Chartered Secretaries Australia. These, and other organisations, also issue a range of guidelines to assist directors. The Commission considers that it would be advantageous for board members to undertake regular training and development, but it is not clear that this needs to be mandated. Ultimately, shareholders should be able to pass judgment on the qualifications and qualities of each director when casting their vote.

6.3 How boards determine pay

The processes a board follows in fulfilling its role to determine executive and director remuneration are influenced by a range of regulatory requirements (including the Corporations Act and ASX listing rules) and non-regulatory guidelines. Furthermore, the processes and rules applicable to determining remuneration differ for NEDs.

How boards determine executive pay

Under the Corporations Act, the board is responsible for determining the remuneration of the CEO. It is common for the board also to determine remuneration for other senior executives (such as those who report directly to the CEO). A typical process for setting CEO and senior executive pay is illustrated in figure 6.3. Examples of how individual companies determine their remuneration levels and structures are presented in box 6.11.

While the board of directors is responsible for determining executive and director remuneration, most major companies establish a remuneration committee. Directors may also seek guidance from consultants — chiefly specialist remuneration consultants, but also taxation and legal advisers.

Details regarding remuneration arrangements must be disclosed in the remuneration report and shareholders are given the opportunity to cast a non-binding vote on this report. In certain circumstances, shareholders are also provided an opportunity to cast a binding vote on termination payments and equity grants to directors and executives. Shareholder engagement in the remuneration process, including disclosure and voting, is discussed in chapters 8 and 9.

Box 6.11 **Remuneration practices at three companies**

Woolworths stated:

> The Board of Directors, assisted by a sub committee of the Board, review all remuneration relative to the rest of the Australian workforce and on appropriate international benchmarks. Information is gathered from a range of sources to assist the decision making process, such as remuneration consultants, publicly available annual reports, benchmarking, macroeconomic indicators and the results of union negotiations. (sub. 91, p. 5)

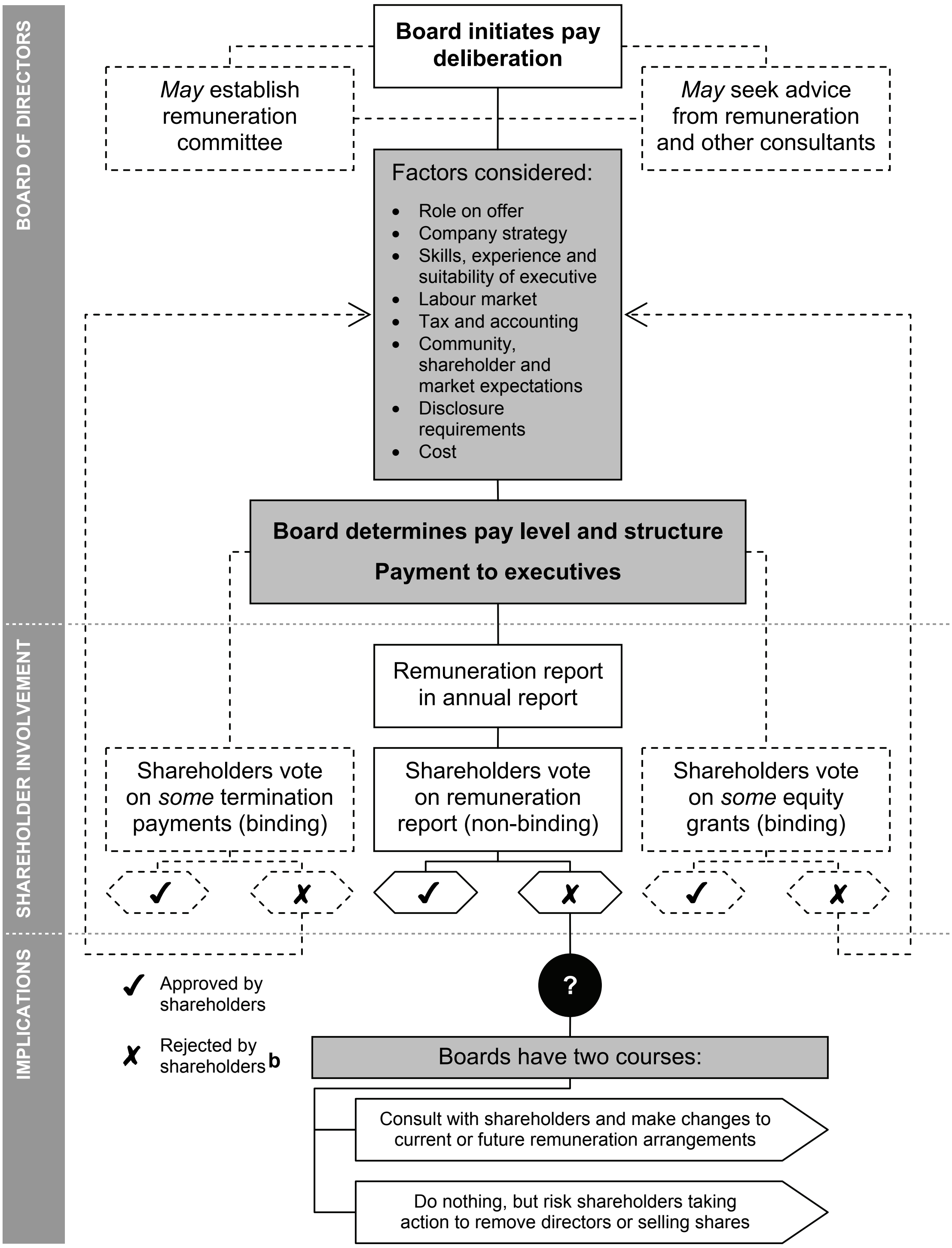
Bluescope Steel advised:

> The Remuneration and Organisation Committee of the BlueScope board oversees executive remuneration policy and practice. This committee is comprised of independent directors only, and chaired by an independent director, being a director other than the Chairman of the Board. (sub. 56, p. 4)

Similarly, Origin Energy also has a remuneration committee, which:

> … comprises three members who are Chair or are members of other major listed company Remuneration Committees who bring considerable knowledge of remuneration levels in other companies. (sub. 93, p. 11)

Figure 6.3 **Processes for setting CEO and senior executives' pay**[a]



[a] The board decides which executives' pay should be under its authority. This is generally the CEO and their direct subordinates. For other executives, this process tends to be simpler, with management having authority to negotiate appropriate remuneration levels. [b] The terms 'approved' and 'rejected' in this context do not necessarily refer to a simple majority of votes. In some cases where the 'no' vote is significant (but does not constitute a majority), boards might still choose to make changes to remuneration policy.

How boards determine NED pay

The board is also responsible for setting the pay of NEDs. In doing so, it draws on the advice and policies developed by the remuneration committee (if established), and also the advice of remuneration or other consultants as necessary (figure 6.4).

As the remuneration committee comprises mainly, or entirely, independent NEDs, committee members essentially determine their own pay. Consequently, companies are required to seek shareholder approval on the maximum fee pool for NEDs (box 6.12). Shareholders are not required to vote each year — a new vote is held only when the board wishes to pay NEDs more than the fee pool allows. The Hay Group indicated that 'increases [in the fee pool] usually only occur every 2 to 3 years' (sub. 84, p. 17).

Once a fee pool is approved, the board (or remuneration committee) then determines how much individual NEDs should be paid. PricewaterhouseCoopers observed:

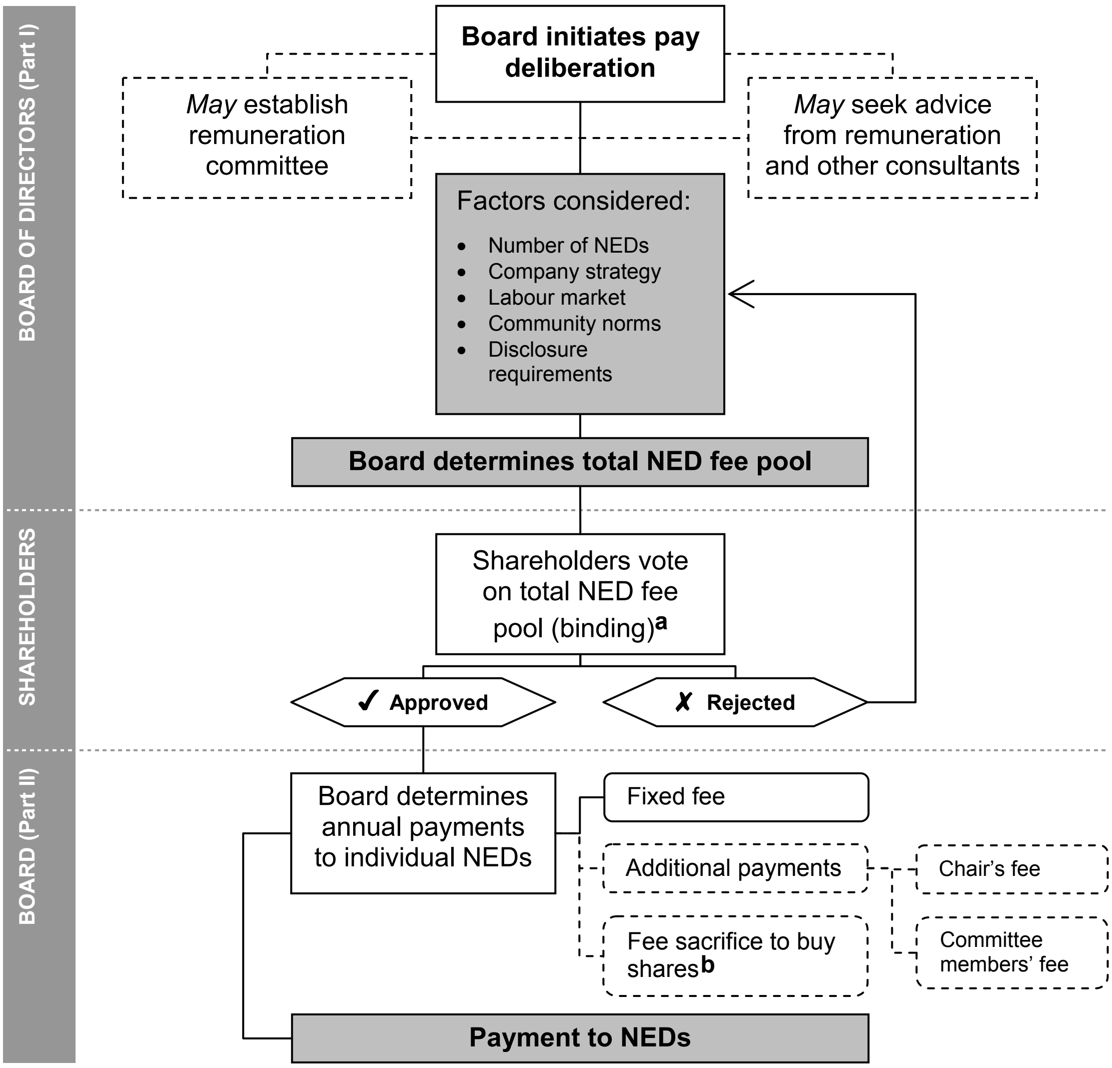
> NED's individual skills and experience do not generally influence their fee, instead the fee tends to be based on the company's characteristics. Characteristics that are typically considered by the Board when setting NED pay are:
>
> - the geographical diversity of the organisation
> - the complexity of the company's operations
> - the market capitalisation/size of the organisation and
> - the number of directors on the board and the impact that this has on time commitment. (sub. 85, p. 5)

Additional payments are sometimes made to those NEDs who serve on board committees, including higher fees for those who chair those committees.

Many companies also offer the opportunity for (or may require) NEDs to sacrifice part of their fees to purchase equity in the company, and may apply holding restrictions to these shares, in order to promote alignment with shareholder interests. According to Ernst and Young (2009), 36 per cent of ASX200 companies operate plans under which NEDs salary sacrifice fees to acquire shares. NEDs' shares do not usually have performance requirements attached, as is the case for executives, in order to distinguish NED incentives from those of executive management and maintain NEDs' independent oversight role of management.

Payments made to NEDs are reported on an individual basis in annual remuneration reports. Although not depicted in figure 6.4, if shareholders object to any individual payment (even after approving the fee pool ceiling), they could vote against the remuneration report.

Figure 6.4 **Process for setting NEDs' pay**



[a] This is not typically an annual vote, but rather a fixed ceiling set by shareholders that can last for a period of years. In this case, a new vote will only be called when this ceiling is to be exceeded. [b] While boards are required by ASX listing rules to pay NEDs by way of a fixed fee, some companies require NEDs to sacrifice at least a portion of this fee into buying company shares.

Box 6.12 **Regulation of NED remuneration**

Under the ASX listing rules, NEDs must be paid a fixed sum and a company must not increase the total amount of director fees — the 'fee pool' — without shareholder approval by ordinary resolution (rule 10.17). This rule does not apply to the salary of an executive director. The board does not need to put the 'fee pool' to a vote each year. A vote is only required where the board wishes to pay NEDs more than the 'fee pool' allows.

This approach is similar to that adopted in the United Kingdom, where the board itself, or where required by the articles of association, the shareholders, determine the remuneration of NEDs within limits imposed by the company's articles of association (the constitution of the company). The articles of association can only be changed by way of a resolution of shareholders.

The structure of the remuneration committee

The process of determining the level and structure of remuneration for the CEO, senior executives and NEDs can be complex and require specialised knowledge. Remuneration committees can allow boards to deal more effectively with complex, specialised remuneration issues and to use directors' time more efficiently (AICD 2007d). There is also an inherent conflict of interest where executives — who are also board members — are able to make decisions regarding their own pay. Remuneration committees are generally composed of independent NEDs, to form an arm's length expert group and thus enhance the integrity of the decision-making process.

The ASX Corporate Governance Council notes that a remuneration committee 'is an efficient mechanism for focusing the company on appropriate remuneration policies', although it acknowledges that 'ultimate responsibility for a company's remuneration policy rests with the full board, whether or not a separate remuneration committee exists' (2007a, p. 35).

The ASX Corporate Governance Council suggests that remuneration committees review and make recommendations to the board on:

- the company's remuneration, recruitment, retention and termination policies and procedures for senior executives
- senior executives' remuneration and incentives
- superannuation arrangements
- the remuneration framework for directors. (2007a, p. 35)

What are the 'rules'?

The ASX Corporate Governance Council (2007a) formally recommends that boards establish remuneration committees. It also 'suggests' (but does not formally recommend, so that 'if not, why not' requirements do not apply) that remuneration committees consist of at least a majority of independent directors, chaired by an independent director and with a minimum of three members. Similar recommendations are contained in the ACSI guidelines (ACSI 2009a).

The AICD considers that boards should establish remuneration committees comprising only NEDs, where the size of the company warrants this (AICD 2009b). However, it notes that for smaller companies, with smaller boards, it may not be practical to have a remuneration committee, suggesting that in these circumstances the entire board may undertake this role directly (sub. 59).

In November, APRA released its final governance standards, which would require APRA-regulated institutions to establish a remuneration committee and to have a written remuneration policy in place by 1 April 2010. APRA may grant an institution approval not to have a remuneration committee in exceptional circumstances and on condition that the board has 'alternative arrangements in place that achieve an equivalent outcome' (APRA 2009c, p. 5). In addition, these standards would require remuneration committees to comprise only NEDs, with a majority of independent directors and an independent chair.

Current practice

According to the ASX (2009a), remuneration committees were in place at 55 per cent of all listed companies in 2007-08, a level virtually unchanged over the previous four years (table 6.4). The main reasons why some listed companies did not establish a remuneration committee included size of entity and resource constraints.

Larger companies are more likely to establish remuneration committees (table 6.4).

- 98 per cent of top 50 companies (by market capitalisation) have remuneration committees (Korn/Ferry International and Egan Associates 2008).
- 85 per cent of the top 250 companies and 72 per cent of mid-cap companies (those ranked 251–400) had a remuneration committee in 2008 (table 6.5).

Of the ASX300 companies that do have remuneration committees, 77 per cent have only NEDs (but not necessarily independent NEDs) as members of the committee (CGI Glass Lewis and Guerdon Associates, sub. 80). Another study (WHK

Horwath 2009a, 2009b) examines the composition of remuneration committees using a rigorous definition of 'independent director'. It finds that the majority of top 400 companies (that have remuneration committees) have a majority of independent NEDs, with remuneration committees in larger companies more independent than remuneration committees in smaller companies (table 6.5). In addition, most top 400 companies that had a remuneration committee had an independent NED chair.

Table 6.4 **Listed companies with a remuneration committee[a], 2003-04 to 2007-08**

	2003-04	*2004-05*	*2005-06*	*2006-07*	*2007-08*[b]
	%	%	%	%	%
All listed companies	55	56	60	58	55
ASX500 entities	na	na	83	84	85

a This represents listed companies that report that they have adopted ASX Corporate Governance Council recommendation 9.2 — that boards should establish a remuneration committee. **b** The ASX Corporate Governance Council changed its interpretation of reporting in 2007-08. Prior to 2007-08, where a company reported the entire board considered remuneration matters, it might have been interpreted as the company having a remuneration committee. In 2008, this is treated as not having a remuneration committee. **na** Not available.

Sources: ASX (2005, 2006, 2007, 2008b, 2009a, pers. comm., 31 July 2009).

Table 6.5 **Remuneration committees in top 400 companies in 2008 annual reports**

	Top 250 companies	*Companies ranked 251–400*
	% all companies	% all companies
Remuneration committee	85	72
Independence[a] of remuneration committee:	% companies with remuneration committee	% companies with remuneration committee
• Independent chair	80	70
• Only independent members	39	22
• Majority independent members	35	32
• No majority independent members	26	46

a WHK Horwath define an independent director as someone who is not a member of management and who: (1) is not, or is not associated with, a substantial shareholder; (2) has not been employed in an executive capacity by the company in the last decade; (3) is not an original founder of the company; (4) is not a professional adviser to the company or is not a principal of a professional adviser to the company; (5) is not, or is not associated with, a significant supplier or customer; (6) has no significant contractual relationship with the company; (7) is free from any interest or relationship, that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; and (8) has been a director for ten years or less.

Sources: WHK Horwath (2009a, 2009b).

What are the benefits of remuneration committees?

As pointed out by CGI Glass Lewis and Guerdon Associates, while remuneration committees are generally considered desirable to improve remuneration processes and outcomes, this is more likely to occur in larger companies:

> … well staffed remuneration committees usually result in superior remuneration disclosure and structures, including remuneration levels consistent with market cap peers, and those often, but not always, occur in well performing companies. Generally, the standards are higher in the bigger companies. (sub. 80, p. 77)

Establishing and maintaining a remuneration committee is not costless. Moreover, boards of smaller companies might have an insufficient number of independents and NEDs to serve on a separate committee. Indeed, for smaller companies, the costs of requiring a separate remuneration committee might outweigh the benefits.

APRA's governance standards — including requiring remuneration committees be established unless special approval is sought — only apply to those entities it regulates. While one possible approach is to extend these requirements to all companies, this could impose significant costs on smaller companies. However, a strengthening of governance arrangements regarding remuneration committees, in line with the course set by APRA, could be achieved through a mix of 'soft' and 'hard' law approaches. For example, given that only 2 per cent of top 50 companies (by market capitalisation) and 15 per cent of top 250 companies do not have remuneration committees (Korn/Ferry International and Egan Associates 2008; WHK Horwath 2009a), one option would be to apply this rule to a sub-section of larger companies through the ASX listing rules.

Should remuneration committees be made more independent?

A remuneration committee comprising only independent NEDs was seen by some participants as an important signal that executives do not have the ability to influence their own pay. Perpetual (sub. DD128) argued that remuneration committees comprising only independent members 'remove actual and perceived conflicts of interest' and promote shareholder confidence. The Australian Manufacturers Workers' Union stated that the independence of those setting remuneration from those receiving remuneration 'is integral to credibility being restored to levels of executive remuneration in Australia' (sub. 127, p. 9).

However, there was also support in submissions for the ASX Corporate Governance Council's suggestion that remuneration committees be chaired by an independent director and comprise a *majority* of independent members (ACSI, sub. 71; BCA, sub. 101; Chartered Secretaries Australia, sub. 57). This approach is also consistent with regulation in some other OECD countries, including the United States and the United Kingdom (box 6.13).

Box 6.13 Remuneration committees in other countries

In the United States, the New York Stock Exchange and NASDAQ listing rules require a compensation (remuneration) committee consisting solely of independent NEDs.

The UK Combined Code states that the board should establish a remuneration committee of at least three, or for smaller companies two, independent NEDs.

In Canada, listed companies must report on an 'if not, why not' basis whether they have established a remuneration committee composing all independent directors and with procedures to ensure that no individual is directly involved in deciding his or her remuneration. These rules are currently under review.

The European Commission recommends that remuneration committees should be set up within the supervisory board (and thus constitute exclusively NEDs) and that the majority of these directors should be independent.

In addition, some participants argued that while the remuneration committee should be responsible for remuneration decisions, it is important that the CEO has a voice in company remuneration strategies, policies, plan designs and actual levels for subordinate employees. Hay Group (sub. DD132) argued this could be achieved by management having an input into committee deliberations but ensuring that decisions were made by independent directors. Regnan (sub. DD159) highlighted the fact that, in its Corporate Governance Guidelines, the ASX Corporate Governance Council suggests that the remuneration committee have a charter which, among other things, sets out procedures relating to non-committee members attending meetings (box 6.14). In the Commission's view, Telstra's requirement that employees (including executives) should not be present at remuneration committee meetings when they have a material personal interest in a matter being considered, seems to be an example of good practice.

Box 6.14 **Remuneration Committee Charters**

The commentary associated with the ASX Corporate Governance Council's Principle 8.1 states that:

> The remuneration committee should have a charter that clearly sets out its role and responsibilities, composition, structure and membership requirements and the procedures for non-committee members to attend meetings (ASX Corporate Governance Council 2007a, p. 35).

Examples of sections in remuneration committee charters that address attendance of non-members:

Qantas — 'Directors who are not Committee Members may attend Meetings' … 'The Chief Executive Officer and the Executive General Manager People are to attend such portion of each Meeting as requested by the Committee Chairman. (The Chief Executive Officer is not to be present when the Committee discusses issues relating to the Chief Executive Officer)' (Qantas 2008, p. 1).

Macquarie — 'All voting Directors of Macquarie may attend Committee meetings. The Managing Director of Macquarie shall normally be invited to attend Committee meetings at the invitation of the Committee but will have no voting rights. Members of management and/or parties external to the Group may be invited to attend any meeting of the Committee or part thereof, however, they may be asked to withdraw from all or any part of a meeting' (Macquarie 2009, p. 3).

Telstra — 'The Group Managing Director, Human Resources, Executive Director Remuneration and Workforce Planning and the Company Secretary attend all Remuneration Committee meetings by standing invitation, but may be asked to leave at any time. The Remuneration Committee may invite other people including any employee of Telstra to attend all or part of its meetings, as it deems necessary or appropriate. If an employee, including an executive director, has a material personal interest in a matter that is being considered at a meeting, he/she must not be present for consideration of that matter' (Telstra 2009, p. 2).

Currently 39 per cent of the top 250 companies and 22 per cent of mid-cap companies (the top 251 to 400 companies by market capitalisation) have only independent members on their remuneration committees (table 6.5). While a requirement for remuneration committees to comprise only independent NEDs puts in place a higher test of independence that could help address the potential for conflicts of interest surrounding remuneration decisions, such a threshold could impose significant costs and would affect most listed companies.

One option to increase the independence of remuneration committees is to elevate the ASX Corporate Governance Council's 'suggestion' on remuneration committee composition to a 'recommendation'. This would mean that companies would need to respond on an 'if not, why not' basis in regard to remuneration committees having a majority of independent directors, being chaired by an independent director and consisting of at least three members (the ASX Corporate Governance Council has indicated support for this approach (ASX 2009g)). An additional 'soft' law option could be to elevate the ASX Corporate Governance Council's suggestion regarding remuneration committee charters from a suggestion to a recommendation (box 6.14).

Encouraging greater independence of remuneration committees through 'soft' law would avoid imposing such arrangements on companies where the benefits are unlikely to outweigh costs. Further, the application of 'soft' law avoids the need for prescriptive requirements regarding independence. Significant complexities arise in determining a 'black letter' law for 'independence of mind'. While the Commission considers that relationship-based definitions are a reasonable proxy for 'independence of mind', they are still only a proxy, and as such some flexibility in determining independence status is necessary. Furthermore, while independence from a major shareholder is less of a concern for remuneration purposes, it is an important element of independence in other contexts. However, it may not be practical to institute differing definitions of independence, defined by particular relationships, for different board functions.

Additionally, mandatory requirements for larger companies — and on an 'if not, why not' basis for all companies — could be considered such that only NEDs (whether or not independent) be appointed to the remuneration committee. A requirement for remuneration committees to comprise only NEDs would affect fewer companies than requiring that remuneration committees comprise only independent NEDs. For example, around 23 per cent of ASX300 companies that have a remuneration committee have executives on it. Introducing this as a recommendation through the ASX Corporate Governance Council in conjunction with a listing rule for ASX300 companies, would provide greater flexibility for smaller companies where such arrangements may not be feasible.

Applying similar requirements to all companies, albeit with differing levels of stringency (according to company size) avoids conceptually inconsistent approaches, and potential problems created by arbitrary company size cut-off points (ASX, sub. DD142). Chapter 11 discusses these options further and provides recommendations.

The role of remuneration consultants

Given the complexity and technical nature of remuneration structures, even remuneration committee members may lack the time, access to market-wide data and depth of knowledge required to develop the most appropriate remuneration packages for senior management. Specialist consultants can provide the board and remuneration committee with useful information and advice.

The AICD observed:

> Remuneration arrangements for executives have become increasingly complex. Boards cannot be expected, in isolation, to be completely across the legal, financial modelling, accounting and tax aspects of many of today's executive remuneration packages, the intricacies of incentive plan design, market trends, and so on. Furthermore, many boards, particularly of modest scale companies, do not engage in this type of activity frequently and may in fact only seek to appoint a CEO every five-to-ten years. It may be the case that no member of the board including its chairman has the experience or skill to undertake these employment negotiations alone. (2009b, p. 10)

Remuneration consultants provide market data (from their own sources as well as remuneration reports) and insights on remuneration trends. They assist boards and/or remuneration committees to determine appropriate pay structures and performance hurdles (Mercer, sub. 41; PricewaterhouseCoopers, sub. 85) and provide insight on taxation, legal and accounting matters relating to remuneration (Egan Associates, sub. 105). The Commission has heard that it is rare for remuneration consultants to make recommendations about the quantum of remuneration. Rather, their role is generally to advise how remuneration can be structured.

Current arrangements

Companies are not required to disclose their use of remuneration consultants, although some choose to do so. These include, for example, BHP Billiton, Iluka Resources and Woodside Petroleum (ACSI, sub. 71, p. 7).

The AICD guidelines on remuneration committees strongly endorse boards obtaining independent advice (AICD 2004). Its guidelines for listed company boards also provide examples of 'good practice' processes, including:

- having in place remuneration processes that incorporate independent opinion, expertise and transparency
- ensuring the board maintains control of negotiations with CEO candidates, and where appropriate, other executives
- obtaining appropriate expert advice, independent of management, when entering into employment contracts with executives and setting their remuneration (AICD 2009b).

In practice, seeking external advice on remuneration matters appears fairly common. Boards, especially from larger companies, generally seek information from a range of consultants when determining remuneration packages. According to a survey by ProNed, a corporate governance adviser, 67 per cent of boards seek independent advice on CEO remuneration (ProNed 2009). Another survey, conducted by AHRI in 2009 (sub. 49), indicated that 83 per cent of boards seek independent advice when negotiating contracts with CEOs.

Some remuneration consultants provide a range of services to both the board and to management. Further, consultants can be contracted by the board directly, by the human resources department on the board's behalf, or by management (box 6.15).

Recently, APRA announced that for financial services businesses, if a remuneration committee (or the board, for companies with approval not to have a remuneration committee) makes use of expert advisers, they should have the power to do so in a manner that ensures that the engagement, including any advice received, is independent (APRA 2009c). Its Prudential Practice Guide notes that 'the board remuneration committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others' and that the committee should not engage 'an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution' (APRA 2009c, p 7).

Box 6.15 **Remuneration consultants — working with the board and management?**

While some companies specialise in providing remuneration advice to boards (such as Guerdon Associates and Egan Associates), others provide advice to both boards and management.

Some advisers are drawn from management and governance advisory companies (for example, Hay Group and Mercer) or major accounting businesses (in particular, the 'big four': Deloitte, Ernst and Young, KPMG and PricewaterhouseCoopers).

Origin submitted that services of independent consultants are retained and instructed by the chair of their remuneration committee. Consultants report directly to the remuneration committee, 'independently of management' (sub. 93, p. 11).

BHP Billiton's remuneration committee receives specialist advice from an external company. They noted that the adviser is directly accountable to the remuneration committee, and does not provide any other services to the company (sub. 45, p. 8).

Woolworths stated that they use different consultants for non-executive directors and senior executives. They reported that there is a rigorous review process to determine the appropriateness of consultants used for providing this type of information (sub. 91, p. 10).

Conflicts of interest?

Many inquiry participants acknowledged the usefulness of the information and expertise from remuneration consultants. However, it was noted that potential conflicts of interest might arise in two ways:

- through lines of reporting, such as when a CEO hires a remuneration consultant to advise the board on the CEO's remuneration
- where a consultant also provides other services to the same company.

In the Commission's public hearings, Mercer reported that the lines of reporting for remuneration consultants can easily be blurred:

> … we do find in a number of cases the board would say to the HR department to find a remuneration consultant, get them to provide us with data, and it actually flows through the management, even though it was a request from the board. (trans., pp. 333–4)

On the second issue, Bebchuk and Fried (2003) have argued that remuneration consultants have strong incentives to use their discretion to benefit the CEO, even where they are not contracted directly by the CEO:

> Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firms. (2003, p. 79)

It is apparent that, in Australia, companies and remuneration consultants are mindful of the potential for conflicts of interest and employ a number of strategies to reduce this risk.

- Some remuneration committees or boards employ the consultant directly, and companies may also limit any other services they receive from the consultant (for example, BHP Billiton, sub. 45).
- Some consultants provide remuneration advice to boards only (CGI Glass Lewis and Guerdon Associates, sub. 80; Egan Associates, sub. 105).
- Others, such as the Hay Group, provide a range of services to boards and management but 'only provide advice to the Board when it comes to executive and/or director remuneration' (sub. 84, p. 26). Further, individual consultants responsible for this advice are not responsible for other services provided to a company.
- Mercer reported that where they provide services to both management and the board, and the board indicates that they need an independent adviser, Mercer will discontinue their executive remuneration work for the board (trans., p. 334; sub. DD139).

The Commission understands that it is likely that the top two companies (in terms of market share) providing remuneration advice to boards in Australia also provide advice to management on remuneration, and to both the board and management on other areas more broadly. While large consulting companies can use ‘Chinese walls’ (information barriers to separate employees who work on remuneration issues) the extent of these practices is not disclosed.

In order to address conflict of interest concerns, some participants suggested changes to the process of engaging remuneration consultants, including: requiring that they be engaged directly by the board (at least on an ‘if not, why not’ reporting basis) (Fidelity International, sub. 83; KPMG, sub. 95; Oppeus, sub. 61); advising the board or management, but not both, on an ‘if not, why not’ basis (CGI Glass Lewis and Guerdon Associates, sub. 80) and that boards should have clearly defined and disclosed systems and procedures to address any potential conflicts (Guerdon Associates, sub. DD119; KPMG, sub. 95; PricewaterhouseCoopers, sub. DD138; Regnan, sub. DD159).

Kym Sheehan also suggested that there may be merit in developing a set of professional standards for remuneration consultants (sub. 36). This is currently occurring in the United Kingdom on an industry-led basis (box 6.16) and could be helpful in Australia for addressing possible conflicts of interest. Ernst and Young (sub. DD136) and PricewaterhouseCoopers (sub. DD138) were also supportive of such an approach.

However, a strict delineation of responsibilities, particularly restrictions on the ability of advisers to boards to liaise with management, might miss potential benefits. PricewaterhouseCoopers argued that consultants working with boards and management can lead to better outcomes in designing performance-based remuneration:

> The main area where there is commonly an overlap between consultants working with both the board and management is when incentive plan structures are being designed. This is necessary to produce optimal outcomes. Liaising with executives enables the adviser to gain a thorough understanding of the business drivers which subsequently enables determination of the most appropriate incentive metrics. In addition, this enables strategic and performance alignment as management can then appropriately cascade metrics down to lower-level employees. (sub. 85, p. 8)

Box 6.16 **International regulation on use of remuneration consultants**

United States — in the United States, the Securities and Exchange Commission requires listed companies to disclose all compensation (remuneration) consultants with any role in determining or recommending the amount or form of executive or director remuneration, stating whether such consultants are engaged directly by the committee and describing the nature and scope of their task. Proposed amendments in July 2009 include requiring disclosure about the fees paid to such consultants if they also provide other services to the company along with a description of those other services (SEC 2009a).

United Kingdom — the UK Combined Code stipulates that where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company.

The Walker Review in the United Kingdom included a draft 'Voluntary Code of Conduct in relation to Executive Remuneration Consulting in the United Kingdom' (Walker 2009). As of August 2009, Deloitte, Hay Group, Hewitt New Bridge Street, Kepler, Mercer, Towers Perrin and Watson Wyatt had all signed up to the draft code. The Code focuses on five fundamental principles: transparency, integrity, competence and due care, objectivity and confidentiality. The draft code also includes good practice guidelines on the ways in which these principles should apply.

However, the Association of British Insurers argues that the Code does not go far enough in acknowledging potential conflicts of interest. They contend that boards should disclose publicly how much they spend on pay consultancy each year, as well as how much management spend on other services from the same consultancy companies (Association of British Insurers 2009).

European Union — a 2004 European Commission recommendation stated that member policies should ensure that companies disclose the name of remuneration consultants whose services were used for determining remuneration policy (European Commission 2004). Subsequently, in April 2009 the European Commission released a further recommendation that stated that consultants who advise the remuneration committee should not advise the company as well (European Commission 2009a).

Ernst and Young similarly considered that it is more efficient and effective if a consultant reports to the board, with a mandate to consult with management (sub. 92). The AICD argued that any requirements regarding the relationship between advisers and management should only apply to advisers on remuneration of directors and key management personnel. Otherwise such an approach has the potential to impose unreasonable regulatory burdens and present practical difficulties for companies that engage a range of advisers on different aspects of remuneration and at various levels of the company (sub. DD149).

Further, Guerdon Associates (sub. DD119) noted that there may be several levels of independence of advisers that may be acceptable to boards and shareholders, such as where advisers provide no advice to management or where services are provided directly to management with the board's knowledge and consent.

Given the potential for conflicts of interest, there would be merit in requiring that if boards engage external advisers, their advice should be commissioned by, and provided directly to, the remuneration committee or board. APRA initially proposed such an approach in its September consultation. However, its final position is that it expects remuneration committees not to engage an adviser who is acting concurrently or has acted recently on behalf of management or any executive of the regulated institution (APRA 2009c). APRA's recommendation makes this compulsory for all APRA-regulated institutions. This is a stronger requirement than that previously proposed and could impinge on the board's ability to seek advice from multiservice providers.

Greater transparency would help

Increasing disclosure on the use of remuneration consultants would help shareholders identify the extent to which the consultants provide advice to the board or remuneration committee, and assess whether the remuneration decisions that boards and remuneration committees make are based on 'independent' (that is, not conflicted) advice. This was supported by some inquiry participants (box 6.17) and is in line with requirements overseas (box 6.16).

Further, there could be benefits from also disclosing whether other services are provided and how potential conflicts of interest are addressed. As is already happening in many cases, it is important that the board and consultancy companies have clearly defined systems and procedures to address any conflicts of interest that may arise. Thus, disclosure requirements could include details of these arrangements.

Regnan (sub. DD159) and the Australian Shareholders' Association both advocated significantly increased disclosures, including about how much the adviser was paid (both for advice provided to the board and for any other services that may be provided to the company) and the board's role in approving such work. The Australian Shareholders' Association noted that 'all too often, listed company boards of all sizes shield themselves by stating that they took advice from 'independent expert remuneration advisers', without shareholders having any way to ascertain who the adviser was, who appointed them, who they reported to and whether they were truly independent' (sub. DD121, p. 6). In addition, Guerdon Associates (sub. DD119) suggested requiring disclosure of company policy (if any) in regard to management contracting its own external advice in relation to their own remuneration.

PricewaterhouseCoopers (sub. DD138), Chartered Secretaries Australia (sub. DD147) and Mercer (sub. DD139) disagreed with such increased levels of disclosure. Mercer argued that requirements regarding disclosure of other work conducted implies that ‘the mere fact that other services are being performed indicates that the consulting advice provided was not objective’ (sub. DD139, p. 19). They also argued that such disclosure may result in competitive or proprietary information being revealed and favours single service providers.

As noted by several participants, boards might not have accepted or followed the advice provided by remuneration consultants. Also requiring disclosure on this aspect was proposed by some, but mandating this may not be workable. Instead, where a consultant has concerns regarding this issue they could include specifications regarding the nature of disclosure in the contractual agreement with the company.

Box 6.17 **Participant's views on disclosure of remuneration consultants**

RiskMetrics argued:

> … the Corporations Act should be amended to require that if a board, in the remuneration report, explicitly notes that it has relied on external advice in setting an aspect of executive remuneration, then the identity of that adviser should be disclosed. (sub. 58, p. 8)

Similarly, ACSI recommended that annual reports should contain information about any remuneration consultants, who appointed them and the services they provided (sub. 71, p. 7). The Australian Shareholders' Association said that disclosure of 'the consultant along with the disclosure of what other services the consultant has provided other than consulting to the board may be of some assistance' (sub. 54, p. 15). Oppeus made a similar suggestion (sub. 61).

CGI Glass Lewis and Guerdon Associates recommended disclosure of all advisers to the board with an opinion by the board on the adviser's independence and the reasons for that opinion (sub. 80). The Finance Sector Union (sub. 39) and Australian Manufacturers Workers' Union (sub. DD127) recommended remuneration consultants should be under similar disclosure requirements as auditors. The Finance Sector Union argued that the Corporations Act should require the consultant's independence be declared in the remuneration report, and the amounts paid to consultants for other services and a statement that (and reasons why) directors are satisfied that provision of these other services did not compromise the independence requirements.

Kym Sheehan argued that all advisers, not just remuneration advisers, to the remuneration committee be disclosed (sub. 36).

Ernst and Young cautioned that if disclosure is mandated, disclosure should only be required where the board 'relied' on the advice (sub. DD136).

The AICD observed that while it supported disclosure, it had:

> … difficulty with this suggestion being mandated in all circumstances. We note that this position is different to that involving an auditor because the auditor prepares a report for shareholders, whereas a remuneration consultation provides advice to the board — advice which may or may not be taken up. Further, the ambit of a remuneration consultant's engagement can vary considerably from company to company, depending in part on the extent to which boards rely on other advisers (e.g. law firms for employment contracts, accountants for data analysis). (sub. 59, pp. 43–4)

Similarly, KPMG acknowledged the potential issues in mandated disclosure if a board chooses not to follow the advice of the remuneration consultant. It advised that standard wording should be developed indicating that the remuneration adviser may have been engaged to look at specific aspects of the report only, that the board may have adopted all, some or none of their advice and that the board remains responsible for the remuneration practices of the company (sub. DD145). Mercer noted that such disclosure is mandated in the United States, and noted:

> We require our clients to run past whatever they're disclosing beforehand and we would push for the board acknowledging where we've provided advice but they've actually not adopted it or made a decision that was contrary to it. (trans., p. 335)

7 Linking pay to performance

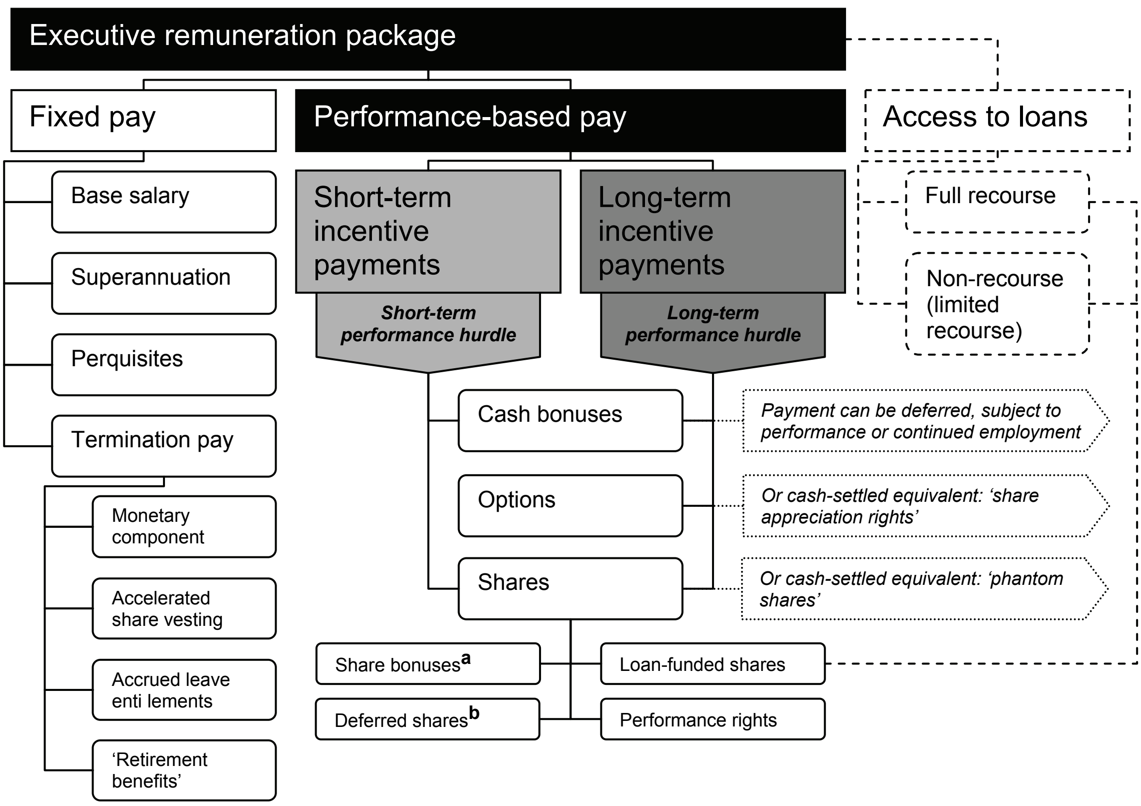
Key points

- Executive performance influences company performance and shareholder value. Different pay instruments and structures can be used to motivate executives to perform in line with the interests of the companies they work for and their shareholders.
- Two key ways that boards link executive remuneration to company performance are by:
  - paying executives in equity, with different instruments presenting different incentive effects and risks
  - using incentive payments based on performance hurdles that relate to company performance. Short-term hurdles can be effective drivers of executive performance when related to appropriate targets, although long-term hurdles are generally more transparent.
- Increased complexity in remuneration structures has responded to the requirements of boards, in the perceived interests of shareholders. In some cases, it is unclear whether this has resulted in company performance outcomes that could not have been achieved by simpler alternatives.
- Non-recourse loans do not appear to be common in Australia. While posing potential problems, such loans could be an effective instrument for some companies (and their shareholders) to align interests, although transparency about their use is required.
- Hedging by executives against company-specific risks associated with equity-based remuneration weakens the intended link between pay and performance.
- Some recent instances of very large termination payments are difficult to justify. Reforms introduced in 2009 will reduce the size of such payments, although, on average, current practice is broadly in line with the new requirements.
- Given the diversity of companies and executives, there is no single ‘right’ answer to structuring pay. Board discretion remains central to ensuring that pay structures are appropriate for each company’s circumstances over time.

7.1 Enhancing performance-based pay

The terms of reference for this inquiry request that the Commission consider the relationship between remuneration and corporate performance. As chapters 3 and 4 have identified, this relationship is multifaceted, with remuneration levels linked to managerial effort, job size and complexity. Complicating this is the indistinct nature of 'performance': executive versus company performance, financial versus non-financial performance, and short- versus long-term performance. As a consequence of the diverse interpretations of 'performance', the term commonly assumes a form synonymous with the concept of 'alignment' — how boards structure executive remuneration to promote the interests of shareholders. (That said, 'alignment' presents its own challenges, given the heterogeneous nature of shareholders.) Incentive compatibility is commonly achieved though the adoption of various pay instruments linked to different performance metrics (figure 7.1).

Figure 7.1 **Forms of executive pay**



[a] Shares may be granted as part of a long-term incentive payment without conditions attached. These 'free' shares, however, are uncommon (table 7.1). [b] Also known as 'restricted stock'.

Why link pay to performance?

Without performance-based pay mechanisms, executives would still have incentives to act in the best interests of shareholders (chapter 2), including through 'reputational concerns, competitive labour markets, and the threat of takeover, dismissal or bankruptcy' (Aggarwal and Samwick 1999, p. 66). Like other people with responsibilities, most executives will also have their own have professional and personal standards, and may feel bound to act ethically and professionally. Regulation can also have some effect (box 7.1).

But these factors might not ensure adequate alignment of incentives. For example, executives might exert less effort than shareholders would like or consume more perquisites ('perks') than agreed (Jensen and Meckling 1976; Fama 1980). Executives might also have incentives to undertake inefficient 'pet' projects that do not maximise company value.

Boards monitor the effort and decision-making of executives, but it is infeasible for them to scrutinise every action and decision. Performance-based pay can therefore be an efficient means of reducing transaction costs in aligning the risk profiles of

Box 7.1 **Regulation and the link between pay and performance**

Generally, corporate law and other regulations do not directly mandate a link between pay and performance or specify how it should occur. However, there are some areas where regulation is involved.

Australian Securities Exchange listing rules 10.17 and 10.17.2 specifically exclude directors (either executive or non-executive) of publicly-listed companies from being paid by way of commission on, or as a percentage of, operating revenue.

Section 588FDA of the *Corporations Act 2001* (Cwlth) permits the recovery of payments made to the directors of a company that enters insolvency (where it is judged that a 'reasonable person' would not make such a payment). While initially proposed as a mechanism for clawing back bonuses to executive directors, the Act is 'deliberately broad and would include (without limitation) base salary payments, options or any other form of accommodation provided to or for the benefit of a director which is deemed by the Court to be excessive' (Launders and Edwards 2002). Payments made up to four years before a company's collapse are potentially recoverable. However, section 588FDA does not apply to payments made to executives who do not serve on the board. Moreover, perceptions of a 'reward for failure' will not always be addressed by the legislation. Bonuses may be paid to the chief executive officer of a company that suffers a decline in share price, but if it avoids bankruptcy, then the Corporations Act does not allow for any 'unreasonable' payments to be recovered.

Disclosure requirements for the remuneration report also include discussion on remuneration policy and its links to company performance (chapter 8).

executives with those of the companies that employ them (box 7.2). Although no mechanism will ever be able to achieve a *perfect* alignment of interests, *improved* alignment can be attained at a lower cost than monitoring. Moreover, given that each company's circumstances differ (and generally change over time), alignment will require a range of approaches across the market, as different pay instruments deliver different incentive effects.

In light of this diversity, the structure of incentive schemes is critical. Incentives intended to achieve a particular outcome could have potentially harmful unintended consequences if inadequately designed. For example, if a manufacturing executive were to receive performance pay based only on cost reductions, he or she might have a perverse incentive to reduce the company's output.

Boards attempt to link executive remuneration to the interests of shareholders by:

- paying executives in shares or options and requiring executives to hold this equity for a period of time. This directly links some of the executive's wealth to the share price and dividends of the company — a key concern for shareholders
- using incentive payments that award additional remuneration based on whether performance hurdles are met. These payments (and hurdles) can be short term or long term. The extent to which remuneration is linked to company performance depends on the performance hurdle used and the threshold for payment.

For larger companies, most executive remuneration structures include a mix of cash and equity-based payments, and also short- and long-term incentive payments (see

Box 7.2 **Structuring remuneration packages to align risk profiles**

Executives and the companies that employ them are all different, so remuneration structures will need to vary.

A key consideration is the relative risk profiles of companies and executives. In the standard case, businesses are risk neutral, whereas their employees tend to be risk averse (Eisenhardt 1989). (The reason being that companies are likely to have a wide range of costs, of which employing workers is just one. By contrast, employees are likely to be highly dependent on their employment as a major — and potentially sole — source of income.) As such, companies will either absorb a greater portion of risk than their employees (that is, pay the employees irrespective of performance) or will need to compensate employees more for accepting risk (a 'risk premium').

In practice, risk profiles across companies and executives will vary. Startup ventures are likely to have a much greater risk tolerance than more established companies, for example. Some executives might prefer greater certainty in remuneration and be willing to trade off potential upside benefits for less downside risk (for example, a greater proportion of fixed pay).

below). Not all payments are directly linked to 'performance' — the key example being base salary (at least while the executive retains his or her position). On average, base salary comprises between one third and one half of a chief executive officer's (CEO's) remuneration (chapter 3). Of course, if an executive received only fixed pay, it is unlikely that he/she would fail to perform. However, performance-based pay can provide incentives for higher levels of performance.

Different forms of incentive-based remuneration present different levels of risk and uncertainty for which the executive will need to be compensated (box 7.3). This is further complicated by a divergence between the costs to companies and the value to executives from executive remuneration (box 7.4).

Equity-based payments

Equity-based payments directly link some of an executive's wealth to the share price (and dividends) of the company, which can be a good proxy for shareholder interests. Although paying in equity can, in principle, be straightforward, in practice, such payments tend to introduce complexity into executive remuneration arrangements, posing challenges for valuation (appendix E). Such complexity can also arise from the array of different payment instruments available.

While the most common forms of equity-based remuneration are shares and 'options' (which offer recipients the right to buy shares at a pre-agreed 'exercise' price), they are seldom granted in Australia without any conditions attached (table 7.1). Performance rights are a type of share grant conditional on performance hurdles being met, while deferred (or 'restricted') shares are conditional on an executive remaining employed by the company for a specified period of time. Other types of share grants can incorporate a combination of these attributes. (Performance rights and deferred shares have been described as 'zero exercise price options' — giving executives the right, subject to meeting specified conditions, to obtain shares at a pre-agreed price (nil). However, in this chapter, references to stock options do not include these forms of equity-based payment.)

More exotic forms of remuneration also exist. For example, 'share appreciation rights' pay executives in cash the value of any share price rises — in effect mimicking the payout from an option, but without the executive ever holding the security itself. Given their structure, the incentive effects associated with such cash-based arrangements are likely to be equivalent in most respects to their equity-settled counterparts. Such forms are not explicitly discussed in this report, but it is worth noting that different forms of remuneration have emerged in response to policy changes to constrain or tax the use of particular instruments.

Box 7.3 **Linking pay to performance is not costless: a stylised example**

Employees generally prefer certainty to uncertainty in their income. This stylised example illustrates that the greater the risk in remuneration faced by executives, the more the 'headline' remuneration amount will need to be to compensate for that risk.

Two executives, Jack and Jill, each have a reservation wage of $600 000 — the minimum amount they would require in cash today for them to be willing to perform the role. However, given the preference of boards and shareholders to align an executive's interests with those of the company, boards might consider different techniques for linking pay to performance. These include: deferring payment, linking payment to the achievement of performance hurdles, and paying in equity. While each of these can potentially improve incentive alignment, they will also be discounted by executives (in potentially different ways), thus affecting the total amount to be paid:

- The value of a dollar today is not the same as a dollar tomorrow. Jack applies a discount rate of 8 per cent, while Jill assumes 5 per cent. To achieve the same value as $1 in cash today, Jack will need to be paid at least $1.08 for deferral of one year; Jill, at least $1.05.
- Performance-contingent payments are, by design, not certain outcomes. Even if executives are confident about their abilities, they are not exclusively responsible for companies' performance. Jack assumes that his probability of meeting the hurdle is 50 per cent. Jill believes her hurdle is more attainable, and assumes a probability for achievement of 80 per cent. To achieve the same value as $1 in cash today, Jack will need to be paid $2 for any amount subject to the hurdle; Jill, $1.25.
- Equity is also less certain than cash, as share prices change over time. The company Jack will work for has share price volatility of 20 per cent over the relevant timeframe, meaning that the minimum outcome is expected to be 80 per cent of the current value. Hence to achieve the same value as $1 in cash today, Jack will need to be paid $1.25 in equity. By contrast, Jill's company has share price volatility of approximately 11 per cent, so she will need to be paid $1.12 in equity.

In this illustrative example, the $600 000 is split equally between cash, deferred cash, performance-contingent cash, equity, deferred equity and performance-contingent equity. For simplicity, tax is excluded and vesting occurs over one year.

From $600 000 'in the hand' to…

	Jack	*Jill*
Cash	$100 000	$100 000
Deferred	$100 000 × 1.08 = $108 000	$100 000 × 1.05 = $105 000
Performance	$100 000 × 1.08 × 2 = $216 000	$100 000 × 1.05 × 1.25 = $131 250
Equity	$100 000 × 1.25 = $125 000	$100 000 × 1.12 = $112 000
Deferred	$100 000 × 1.25 × 1.08 = $135 000	$100 000 × 1.12 × 1.05 = $117 600
Performance	$100 000 × 1.25 × 1.08 × 2 = $270 000	$100 000 × 1.12 × 1.05 × 1.25 = $147 000
Total future pay offered to achieve certainty-equivalent wage of $600 000 =	**$954 000**	**$712 850**

Box 7.4 **The cost to the company versus the value to the executive**

Discussions around remuneration generally consider the cost faced by companies (and, by extension, shareholders) in employing executives. But another relevant factor is how executives themselves value the different components of their remuneration, as this influences the effectiveness of performance incentives.

The divergence between cost (to the company) and value (to the executive) can stem from the properties of different pay instruments. For example, a cash payment made today will probably be worth much the same to an executive as its cost to the company. But equity-based remuneration is likely to be different. In the case of granting shares acquired on market, the company faces a one-off cost (buying the shares), while the executive faces not only the initial benefit of remuneration (the shares as income), but also the changes in the share price over time (the shares as wealth, affected by capital gains and losses).

As box 7.3 suggests, deferred payments and the application of performance hurdles can have similar effects. Additional factors that can contribute to a divergence between cost and value are portfolio risk (that is, the relative concentration of an executive's wealth in the company's stock) and transaction costs (faced by boards in monitoring executive performance and designing 'optimal' incentive pay structures).

Table 7.1 **Equity-based payments: extent of use, 2002-03 to 2007-08**

Remuneration of CEOs at ASX100 companies

	2002-03	*2003-04*	*2004-05*	*2005-06*	*2006-07*	*2007-08*
Options	%	%	%	%	%	%
Proportion of CEOs	46	51	43	39	54	49
Proportion of total remuneration[a]	11	8	7	6	9	11
Performance rights						
Proportion of CEOs	19	28	29	39	30	54
Proportion of total remuneration[a]	4	4	6	8	9	12
Deferred shares						
Proportion of CEOs	13	21	28	24	23	11
Proportion of total remuneration[a]	3	3	6	4	6	2
Loan-funded shares[b]						
Proportion of CEOs	12	8	9	11	6	9
Proportion of total remuneration[a]	1	–	1	2	–	1
'Free' shares[c]						
Proportion of CEOs	–	1	3	–	1	3
Proportion of total remuneration[a]	–	–	–	–	–	–

[a] Based on reported values disclosed in remuneration reports, not pay actually realised. See chapter 3. [b] May be offered on 'non-recourse' or 'full recourse' terms. See section 7.2. [c] Shares granted without condition as a long-term incentive payment. **–** Nil or rounded to zero.

Source: ACSI (2009d).

Options versus actual shares

Different types of equity-based payment can have different incentive effects (table 7.2). One instrument that has become particularly contentious is options. (Appendix E discusses the mechanics of options values more extensively.)

Remuneration in options can magnify the returns to executives (and costs to companies) of share price rises between grant and exercise, compared to remuneration in shares. Since options are valued at less than the value of the underlying shares, $1000 remuneration in options will give the executive access to more shares than if he or she simply received $1000 in shares. However, if the share price fell below the exercise price between the grant date and expiration (the options are 'underwater'), the executive would receive no equity, even if performance hurdles were met. By contrast, shares will generally retain some value.

Some concerns relate to the lack of a consistent technique for valuing options for disclosure purposes, which may reduce transparency and, in particular, obscure from shareholders how much executives are actually being paid (chapter 8). Concerns also stem from US accounting scandals in the early 2000s, including the collapse of Enron. Some argued that senior executives at that company were focused on driving the share price to unsustainably high levels in the short term in

Table 7.2 **Upside, downside**

The incentive effects of different forms of pay

	If share price rises	*If share price falls*
Cash	• No direct benefit from improved company performance	• No cost — insulated against downside risk
Shares	• Executive enjoys full benefit of share price increases • Incentive to improve company performance to increase value of shares and dividends • As executive prepares to depart the company, may have incentive to reduce share price volatility by taking less risky decisions (which might not maximise company performance)	• Executive's wealth progressively eroded as share price falls • Incentive to improve company performance to increase value of shares and dividends • As executive prepares to depart the company, may have incentive to reduce share price volatility by taking less risky decisions (which might not maximise company performance)
Options	• Upside magnified — executive gains full benefit of any share price increases above the exercise price • Incentive to improve company performance to increase value of options	• Intrinsic value of options is nil when share price is less than exercise price • Incentive to avoid share price falling below exercise price • However, where share price falls significantly below exercise price, weak incentive to try and improve company performance

order to realise value from stock options (Samuelson 2002). Rather than strengthening the alignment of executives' interests with those of shareholders, options (in that scenario) created a divergence between the two.

However, options are not *inherently* poor instruments for remuneration. But they are likely to have been poorly structured in some instances, leading to detrimental outcomes. Options will be better suited to companies in specific circumstances, with size and stage of development likely to be important factors. For example, the Australian Institute of Company Directors (AICD) suggested:

> The level and form of executive remuneration packages decided upon is also influenced or constrained by the company's working capital position. For example, a greater emphasis on equity-based arrangements (e.g. options) as opposed to cash is often evident for smaller companies, particularly start-ups. It is important to recognise that there are approximately 2000 ASX-listed companies and the vast majority of these are [small or medium enterprises]. (sub. 59, pp. 24–5)

Importantly, new ventures are likely to be riskier than established businesses and will want to attract suitable executive talent to maximise their chances of success. However, startups are also likely to be cash constrained, making options an attractive instrument: they minimise the initial cash outlay for the company, while offering the executive a potentially high payoff if the company performs well.

Just as options magnify the upside potential relative to a grant of shares, their incentive effects on the downside are also quite different. For an option, once the share price falls below the exercise price, it has no intrinsic value. Hence, further declines in the share price do not affect the executive's wealth. Where the share price falls significantly below an option's exercise price and is not expected to exceed the exercise price before the option expires, the performance incentive virtually disappears. In these circumstances, the executive receives no benefit from generating a modest improvement in the company's performance.

In the case of shares, however, the executive's wealth is progressively eroded the further the share price falls. The worse the company performs, the more the executive loses. Furthermore, any improvement in the share price translates into a benefit to the executive. Hence, the executive still retains a strong interest in improving the company's performance even after a significant decline in value.

Share grants are unlikely to be as useful for new ventures, which by definition start off with little value, but have much upside potential. By contrast, 'mature' companies will have greater concern about the incentive effects when share prices fall. A stronger, although not perfect, alignment of interests between executives and shareholders may be achieved where the executive faces the same effect as shareholders from persistent share price declines.

Thus, there is not a simple answer to the question of what the 'right' equity-based instrument is. A remuneration structure that works well at one company might prove disastrous at another. And what works well for an individual company at one point in time might not at another. Choosing the best equity-based instrument/s therefore requires careful consideration of the company's circumstances. Simply following market trends might be unhelpful if boards (or, indeed, shareholders) do not fully understand the implications of using increasingly sophisticated forms of pay.

Equity-based payments to non-executive directors

Incentive schemes for executives are predicated on the basis that they align management's interests with those of the company and shareholders. A similar argument applies to non-executive directors (NEDs). CGI Glass Lewis argued:

> Corporate governance best practice dictates, and shareholders believe, that NEDs should acquire and maintain meaningful shareholdings in the company to align their interests and risk profile with the interests and risk profiles of shareholders. Shareholders believe, and common sense supports that belief, that having 'real skin in the game' will operate on the hip pocket of the NED, which aligns with the hip pocket of shareholders, and thereby apply the most effective focus for the NED's fiduciary duty to act in the best interest of the company and its shareholders overall. (2009, p. 4)

The important role of NEDs in monitoring executives nevertheless presents the potential for conflicts of interest. If NEDs were remunerated in the same way as executives, then the independence of the board (particularly on remuneration matters) could be undermined, with the decisions they make with regard to executive pay having an impact on their own earnings. In addition, setting performance hurdles for non-executives would be illogical, since the board does not have any day-to-day responsibilities for managing the company. Indeed, performance-based payments to NEDs could be dangerous, if they encouraged boards to endorse investments and strategies that might deliver short-term gains, but were not prudent over a longer timeframe.

For these reasons, performance-related pay for NEDs is generally advised against. For instance, the Australian Council of Super Investors (ACSI) states that independent NEDs should 'not participate in any … performance-related remuneration schemes that apply to executives within the company' (2009a, p. 10). Recommendation 8.2 of the ASX Corporate Governance Council (2007a) principles and recommendations stipulates that the structure of NEDs' remuneration should be clearly distinguished from executives' remuneration. The situation is similar in Europe, with stock options identified as inappropriate for NEDs (box 7.5).

Box 7.5 **Remuneration of NEDs: international experience**

The UK Combined Code stipulates that remuneration of NEDs should not include share options. If options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the NED leaves the board (FRC 2008).

The European Commission (2009a) has recommended that NEDs not be paid with share options.

- In the Netherlands, NED remuneration is agreed to by shareholders. (In practice the NEDs will themselves draw up a proposal for remuneration packages, which is then submitted to the company's general meeting of shareholders for approval.)
- Both Belgium and Germany specify in their governance codes that the remuneration of NEDs should take into account their role as ordinary board members, and their specific roles, as chair of the board, chair or member of board committees, as well as their resulting responsibilities and time commitments. However, in Belgium the code specifically stipulates that NEDs should not be entitled to performance-related remuneration such as bonuses, share-based long-term incentive schemes, fringe benefits or pension benefits.
- In Denmark, Danish courts have ruled that board members must receive equal payment, unless higher pay is justified due to workload (for example the chair of the board is generally paid considerably more than other board members). The Danish Committee on Corporate Governance has proposed that NEDs should not be granted stock options (ECGI 2008).

Australian Securities Exchange (ASX) listing rule 10.17.2 mandates that NEDs of publicly-listed companies be remunerated only by way of a fixed sum, either as cash or shares. For example, the Investment and Financial Services Association states:

> Non-executive directors should acquire equity participation independently and from their own resources. In particular, non-executive directors should not participate in a share or option scheme designed for the executives whose role is to manage the company on a daily basis. The non-executive directors' role is to assess effectively the performance of the company and its executives, and a conflict of interest would be created if directors participated in a similar scheme to the executives. (2009, p. 24)

Many companies have established share schemes for NEDs, allowing (or even requiring) them to 'salary' sacrifice some portion of their directors' fee for the purpose of buying equity. While few inquiry participants commented specifically on such arrangements, those who did tended to view them favourably (for example, PricewaterhouseCoopers, sub. 85, p. 5).

Fee sacrifice schemes facilitate NEDs' ownership of equity in the companies they serve (the 'skin in the game' factor), while remaining separate from the incentive schemes provided to executives. As such, fee sacrifice schemes help to mitigate potential conflicts of interest, while still retaining an appropriate alignment of interests between NEDs and the company.

Performance hurdles

A common way of encouraging executives to act in the best interests of the company over time is the use of payments (either in cash or equity) linked to performance hurdles. Companies typically apply separate hurdles for short-term and long-term incentive payments.

Although not contained in a formal recommendation, the ASX Corporate Governance Council (2007a) advocates the use of performance hurdles in executive remuneration packages. In particular, it supports *relative* performance measures — generally 'relative total shareholder return' (relative TSR). Under this metric, the company's performance (measured in terms of share price movements, accounting for dividend payments) is benchmarked against either a specific group of peers or the broader sharemarket index, in order to strip out the effect of sector-specific or general market movements.

Data from Hay Group reveal that, in recent years, long-term incentive payments have commonly been subject to a performance measurement based on relative TSR (table 7.3). Long-term performance hurdles can also include accounting measures, such as earnings per share (EPS) (box 7.6).

Short-term incentives may also adopt financial hurdles. However, these tend to operate in conjunction with hurdles that emphasise an executive's individual performance or internal key performance indicators. ACSI observes:

> [Short-term incentive plans] usually have performance indicators relating to: (a) 'quantitative' metrics such as company-wide accounting performance (such as earnings before interest, depreciation, tax and amortisation), business-division performance, successful completion of major projects, etc; and (b) 'qualitative' metrics such as customer or employee satisfaction. An increasing trend has been for companies to also include measures relating to sustainability (such as occupational health and safety) in annual bonus programs … (2008c, p. 2)

Box 7.6 **Measuring long-term performance**

Assessing a company's performance is critical for shareholders in making investment decisions. Yet there is tremendous diversity amongst the ranks of shareholders and the companies they invest in. The metrics that are used to assess company performance can take many different forms. These affect the nature of the hurdles that are used for options, performance rights and other equity-based payments.

Total shareholder return

TSR is related to a company's share price performance, adjusted for the effect of dividend payments. (Although some companies still use the share price as a performance metric, the share price is susceptible to manipulation through such factors as the payment of dividends. TSR, by contrast, avoids this problem.) However, TSR performance may be inflated by general sharemarket rises (or depressed by market falls), resulting in executives being rewarded (or penalised) for factors over which they have no influence.

Consequently, many companies have chosen to measure TSR performance relative to a group of peers. These may be specific competitors (either domestic or global), an industry-specific index, or the broader sharemarket. Relative TSR is able to strip out the effect of sectoral or market-wide trends. However, the effectiveness of hurdles relying on this metric will depend largely on the appropriateness of the peer group. Companies might not always have strong comparators (KPMG, sub. 95). Additionally, some shareholders might be concerned by payments made to executives on the basis of relative TSR if a company's performance is weak in absolute terms, but simply not as poor as the chosen peer group's performance (Australian Shareholders' Association, sub. 54, p. 19). Certainly if a company outperforms its peers in a tough environment, it seems reasonable for its executives to be rewarded. It is possible that, with a different executive team in place, the company would have performed worse. However, if the peer group is inappropriately selected, this could lower the absolute performance level required to meet the hurdle.

Accounting measures of performance

While measures of performance based on the sharemarket are particularly common in setting hurdles, some companies adopt accounting-based measures. There are a number of metrics in this area, most prominently EPS, but also return on equity, net profit after tax and earnings before interest, tax, depreciation and amortisation.

Like TSR, accounting metrics tend to be observable by those outside the company. WorleyParsons says EPS growth is a useful metric, as it 'provides a clear line of sight between executive performance and Company performance' (2008, p. 23). Macquarie Group adopts return on ordinary equity (relative to a peer group) as a measure of performance because it is 'correlated over time with total shareholder returns' and because it is an area in which the executive can exercise 'considerable control' (2008, p. 74).

(Continued next page)

Box 7.6 (continued)

Some participants expressed concern about accounting hurdles as being too easy to manipulate. For instance, Stern Stewart and Co. argued:

> … accounting measures of performance are … notoriously subjective. Be it rates of depreciation or amortisation, mark to market valuations, fair value adjustments — the list goes on — [chief financial officers] are able to swing the reported result in a way that can be material to their bonus, while staying within the definition of profit provided by the accounting standards. (sub. 53, p. 6)

Nevertheless, accounting-based hurdles are supported by both the ASA (sub. 54) and ACSI (sub. 71), where used in conjunction with a hurdle based on shareholder value (such as relative TSR). However, ACSI would not generally support performance rights granted solely on the basis of an absolute accounting-based hurdle.

Risk-adjusted measures of performance

Efforts to align the interests of executives with those of shareholders have become more complex over time, with new performance metrics proposed for different purposes. One example is 'economic profit' (also known as 'economic value added' or 'risk-adjusted return on capital'), which adjusts company profits for capital costs.

While currently uncommon, economic profit might be adopted more frequently, particularly in the financial sector, given its implications for risk. (The Australian Prudential Regulation Authority has recommended that banks and insurers take greater account of risk in remuneration practices. See box 5.4 in chapter 5.) As riskier businesses tend to face higher capital costs, executives will have an incentive to avoid 'excessive' risk-taking.

However, such an approach does face practical constraints. As the Australian Bankers' Association observed, economic profit does not completely account for share price changes (and thus obscures the link to creating shareholder value) and is difficult to estimate (sub. 70, p. 25). CGI Glass Lewis and Guerdon Associates suggest that economic profit is 'complex and difficult to understand, expensive to administer, requires discretionary judgment, difficult to audit for fair assessment, and not well suited to less capital intensive companies' (sub. 80, p. 28).

Non-market measures of performance

Some companies base long-term performance hurdles on the achievement of specific targets or completion of specific milestones. For example, the Commonwealth Bank (2008) partially links long-term incentive payments to improvements in the bank's customer satisfaction rankings. This can be a useful approach if the goals are effectively aligned with long-term performance. However, shareholders might have concerns about the transparency of such metrics, particularly where they are linked to internal performance indicators that cannot be objectively verified. Problems could also emerge if the emphasis of certain objectives causes executives to address those areas at the expense of others. Such a distortion would have the potential to impair long-term company performance.

Table 7.3 Performance hurdles over time: extent of use, 2000-01 to 2006-07[a]

Hay Group sample of ASX-listed, overseas-listed and unlisted companies[b]

	2001[c]	2002[c]	2003[c]	2004	2005	2006	2007
Options	%	%	%	%	%	%	%
Relative EPS				0	0	0	0
Absolute EPS	73[d]	74[d]	90[d]	5	13	13	14
Relative TSR				63	61	57	62
Absolute TSR				0	9	9	10
Time-tested only	27	26	10	26	22	35	29
Other			–[e]	11	9	9	5
Other equity							
Relative EPS				8	3	0	0
Absolute EPS			54[c]	4	8	7	11
Relative TSR				80	75	79	73
Absolute TSR				0	8	7	7
Time-tested only	90–100[f]	90–100[f]	46	8	8	19	16
Other			–[e]	16	14	10	8

[a] Proportions will not always sum to 100 per cent as companies may adopt more than one hurdle for incentive schemes. [b] Nearly half of the Hay Group sample comprises non ASX-listed entities. Of ASX-listed entities surveyed in 2008, the majority were ranked within the top 50 companies by market capitalisation, although the sample's reach extended beyond the top 300. [c] Data reported for 2001–03 based on qualitative descriptions. [d] 'Almost all' hurdles based on relative TSR. However, two companies reported having an EPS hurdle linked to inflation (although whether this is for options or for other types of equity is not specified). [e] Two companies base hurdles on share price growth (although whether this is for options or for other types of equity is not specified). [f] Only a 'small number of [other equity] plans have performance criteria' (that is, EPS or TSR hurdles). This implies virtually all 'other equity' incentive plans are deferred share schemes rather than performance rights. **–** Nil or rounded to zero.

Source: Hay Group (2009).

How are performance hurdles used?

To identify how performance hurdles are used, the Commission analysed the short-term and long-term incentive payment performance hurdles presented in the remuneration reports of the top 20 ASX-listed companies by market capitalisation, along with a further 10 companies randomly selected from the ASX100 index (excluding the top 20).

A summary of short-term hurdles is presented in tables 7.4 and 7.5, while long-term hurdles are presented in tables 7.6 and 7.7. Further details from remuneration reports in 2009 are contained in box 7.7.

Table 7.4 **Short-term performance hurdles for top 20 companies**[a]

	Performance hurdles				
Company	*Non-financial hurdles*	*Financial hurdles*	*Specify relative weighting?*[b]	*Specify level performance for payment?*	*Form of payment*
BHP Billiton	✓	✓	✗	✗	Cash and deferred shares/options
Rio Tinto	✓	✓	✗	Part[c]	Senior execs: 100% deferred shares Other execs: 50% cash and 50% deferred shares
Commonwealth Bank	✓	✓	✗	✗	67% cash and 33% deferred shares
Woodside	✓	✓	✗	✗	67% cash and 33% deferred shares[d]
Telstra	✓	✓	50:50	✗	CEO: 50% cash and 50% deferred shares Other execs: 75% cash and 25% deferred shares
National Australia Bank	✓	✓	✗	✗	Primarily deferred shares[e]
Westpac	✓	✓	✗	✗	CEO: 60% cash[e] and 40% deferred shares Other execs: 75% cash[e] and 25% deferred shares
ANZ	✓	✓	✗	✗	50% cash, 50% deferred shares/options[e]
Fortescue Metals[f]	✓	✓	✗	✗	Cash, deferred shares and/or superannuation
Westfield	✓	✓	✗	✗	Cash[d]
Woolworths	✓	✓	30:70	✗	Cash
Wesfarmers	✓	✓	30–50:70–50	✗	Cash[g]
QBE Insurance	✓	✓	✗	✗	Cash[h]
CSL	✓	✓	✗	✗	Cash
St. George Bank	✓	✓	✗	✗	Cash, deferred shares and/or superannuation
Origin Energy	✓	✓	40:60[i]	✗	Cash
Leighton Holdings	✓	✓	✗	✗	Cash

[a] Top 20 ASX-listed companies by market capitalisation as at 30 June 2008. Details in this table relate to 2008 annual reports. [b] Does the remuneration report specify the relative weighting between non-financial and financial hurdles? [c] Level of performance specified for safety targets, however the targets for business/financial and personal performance objectives are unclear. [d] Or cash-settled equivalent. [e] Some employee choice. [f] No bonuses in 2008. [g] Can be partly or entirely deferred into shares as part of a salary sacrifice arrangement. [h] Achievement of any short-term incentive hurdle also provides access to a 'deferred compensation' scheme, entitling recipients to shares or options. [i] For the managing director. For other senior executives, at least 33 per cent of the short-term incentive to be based on financial targets.

(Continued next page)

Table 7.4 (continued)

Company	Performance hurdles: Non-financial hurdles	Financial hurdles	Specify relative weighting?[b]	Specify level performance for payment?	Form of payment
Macquarie Group	✓	✓	✗	✗	Cash, deferred shares and managed fund equity[j]
Newcrest Mining					
• 'Salary at risk'	✓	✓	50:50	✗	Cash
• 'Medium term incentive'	✗	✓	..	✓	Deferred shares
News Corporation[k]	✗	✓	..	✗	Cash and deferred shares[d]

[j] 20 per cent of 'profit share' must be retained as equity in a Macquarie-managed fund for ten years. [k] Also listed on the New York Stock Exchange. Remuneration disclosure is consistent with US standards. .. Not applicable.

Sources: Company annual reports.

Table 7.5 **Short-term performance hurdles for other selected companies[a]**

Company	Performance hurdles: Non-financial hurdles	Financial hurdles	Specify relative weighting?[b]	Specify level performance for payment?	Form of payment
ABB Grain	✓	✓	✗	✗	Cash
Alumina	✓	✓	50:50	✗	50% cash and 50% deferred shares
AMP	✓	✓	✗	✗	Cash
Arrow Energy	✓	✓	✗	✗	CEO: cash Other execs: shares
Boral	✓	✓	50:50[c]	✗	Cash
ConnectEast Group[d]	✓	?	✗	✗	Cash
Metcash	✓	✓	✗	✗	Cash
Suncorp-Metway	✓	✓	✗	✗	Cash[e]
Transurban Group	✓	✓	✗	✗	Cash
WorleyParsons	✓	✓	40:60	Part[f]	Cash

[a] These ten companies were randomly selected from the ASX100 index (excluding the top 20 companies). Details in this table relate to 2008 annual reports. [b] Does the remuneration report specify the relative weighting between non-financial and financial hurdles? [c] For most executives, although 33:67 for 'Executive General Managers'. [d] 'Milestone retention bonuses' were also paid (in cash) for achieving key milestones. [e] Employee can direct cash bonus into shares or superannuation contribution. [f] No payment if net profit after tax is less than 90 per cent of Board approved budget. Size of payment determined by outcome against key performance indicators.

Sources: Company annual reports.

Table 7.6 **Long-term performance hurdles for top 20 companies**[a, b]

	Hurdle is relative TSR?		*Other hurdle?*	
Company		*Comparator group(s)*		*Hurdle type(s)*
BHP Billiton	✓	Mining companies (75%), oil and gas companies (25%)	✗	
Rio Tinto	✓	HSBC global mining index, 10 international mining companies[c]	✗	
Commonwealth Bank	✗		✓	NPAT, customer satisfaction
Woodside	✓	11 international peers (oil and other energy, resources companies)	✗	
Telstra	✗		✓	Return on investment, TSR
National Australia Bank	✓	ASX50 companies (50%), top 12 ASX-listed financial companies (50%)	✓	Cash earnings, ROE growth
Westpac	✓	Top 13 ASX-listed financial companies	✗	
ANZ	✓	10 ASX-listed financial companies	✗	
Fortescue Metals[g]	✗		✓	Share price[h]
Westfield	✗		✓	Varies[j]
Woolworths	✓	ASX100 companies, excluding finance and resources sectors	✓	EPS growth
Wesfarmers	✗		✓	Relative ROE[k]
QBE Insurance	✗		✓	ROE
CSL	✓	ASX100 companies, excluding finance and resources sectors	✓	EPS growth
St. George Bank	✓	Top 13 ASX-listed financial companies	✓	EPS growth
Origin Energy	✓	ASX100 companies	✗	
Leighton Holdings	✓	ASX100 companies	✓	EPS growth
Macquarie Group	✗		✓	Relative ROE[m]
Newcrest Mining	✓	Selection of peers from FTSE Gold Mine index	✗	
News Corporation[n]	✗		✓	Operating profit[o]

[a] Top 20 ASX-listed companies by market capitalisation as at 30 June 2008. Details in this table relate to 2008 annual reports. [b] Acronyms are as follows — CSE: cash-settled equivalent; EPS: earnings per share; NPAT: net profit after tax; ROE: return on equity; PR: performance rights (or equivalent); TSR: total shareholder return. [c] Three long-term incentive schemes operate: a share option plan (with performance measured against the HSBC global mining index over a three year period); the 'mining companies cooperative plan', which pays in either shares (performance rights) or cash (with performance measured against 10 international mining companies over a four year period); and the 'management share plan', which is not available to directors of the company (and for simplicity, has been excluded from this table). [d] Both hurdles relative to a peer group, but relative weighting not stated. Hurdle for customer satisfaction specified, similar details associated with NPAT performance are not. [e] Options linked to relative TSR, PR to earnings hurdle.

Specify level performance?		Vesting (years)	Form of payment	Company
Relative TSR	Other hurdle			
✓	..	5	PR	BHP Billiton
✓	..	3 or 4[c]	Options, PR or cash	Rio Tinto
..	Part[d]	3	PR	Commonwealth Bank
✓	..	3–4	PR (or CSE)	Woodside
..	✓	2–4	Options	Telstra
✓	✗	3	Options and PR[e]	National Australia Bank
✓	..	3–5	Options and PR[f]	Westpac
✓	..	3	PR	ANZ
..	✗	3–7[i]	Options[h] and PR[i]	Fortescue Metals[g]
..	✗	3–4	Cash-settled PR	Westfield
✓	✓	3–4	Options and PR	Woolworths
..	✓	5	PR	Wesfarmers
..	✗	3	PR	QBE Insurance
✓	✓	2–5	Options and PR[l]	CSL
✓	✓	2–5	Options and PR	St. George Bank
✓	..	3–5	Options and PR	Origin Energy
✓	✓	3–5	Options	Leighton Holdings
..	✓	2–4	Options	Macquarie Group
✓	..	3	PR	Newcrest Mining
..	✗	4	Shares (or CSE)	News Corporation[n]

[f] Only CEO is eligible for PR. [g] No long-term incentive payments in 2008. [h] The sole performance hurdle for options is that the exercise price must exceed the share price. No vesting period is specified. [i] While Fortescue offers a PR plan, it reports that it has never paid employees through this scheme. Relevant performance hurdle not specified, but vesting/retesting period is specified. [j] Varies each year. In 2008, the hurdle was operational segment earnings growth (75 per cent) and targeted level of project development starts (25 per cent). In 2009, only operational segment earnings. [k] Relative to ASX50 companies. [l] Options linked to EPS growth, performance rights to relative TSR. [m] Relative to ASX100 companies. [n] Also listed on the New York Stock Exchange. Remuneration disclosure is consistent with US standards. [o] Board discretion. .. Not applicable.

Sources: Company annual reports.

Table 7.7 **Long-term performance hurdles for other selected companies[a, b]**

Company	Hurdle is relative TSR?	Comparator group(s)	Other hurdle?	Hurdle type(s)
ABB Grain[c]	✓	ASX200 companies (excluding mining sector), AWB and GrainCorp	✓	Share price, ROE
Alumina[d]	✓	100 ASX-listed entities, 30 international mining companies	✗	
AMP	✓	50 industrials from ASX100 companies	✗	
Arrow Energy	✗		✓	Rolling EBITDA
Boral	✓	ASX100 companies	✗	
ConnectEast Group[f]	..		..	
Metcash[g]	✗		✓	EPS growth
Suncorp-Metway	✓	Top 50 ASX100 companies (excluding property trusts)	✗	
Transurban Group	✓	ASX100 industrials	✓	EBITDA
WorleyParsons	✓	ASX-listed companies ranked 50–150 by market capitalisation	✓	EPS growth

[a] These ten companies were randomly selected from the ASX100 index (excluding the top 20 companies). Details in this table relate to 2008 annual reports. [b] Acronyms are as follows — EBITDA: earnings before interest, taxes, depreciation and amortisation; EPS: earnings per share; PR: performance rights (or equivalent); ROE: return on equity; TSR: total shareholder return. [c] Options are granted according to a share price target. PR are granted according to three hurdles: improvements in return on equity (weighted at 50%), TSR relative to the ASX200 (25%) and TSR relative to key competitors (AWB and GrainCorp) (25%).

The common use of deferred share schemes by some of Australia's largest companies (nine of the top ten by market capitalisation) suggests that short-term incentive payments can be designed to emphasise long-term, sustainable performance. Some companies (for example, Newcrest Mining) have begun to label such schemes 'medium-term incentives'. However, a lack of detail about the terms under which such payments are granted might give rise to shareholder concern. That said, there can be legitimate commercial reasons for not disclosing the metrics for short-term hurdles — for example, where this might signal the company's immediate plans and provide material commercial advantage to competitors.

Almost all companies in the sample stated that they used a mix of hurdles for their short-term incentive payments, but remuneration reports tended to mention only broadly what these indicators covered. The relative weighting between different indicators was rarely disclosed. In almost all cases, the remuneration report did not specify the link between the measured performance outcomes and the incentive payments made. (Disclosure is discussed in chapter 8.)

Specify level performance?		Vesting (years)	Form of payment	Company
Relative TSR	Other hurdle			
✓	✓	3	Options and PR	ABB Grain
✓	..	3	PR	Alumina[d]
✓	..	3	PR	AMP
..	✗	3	Options[e] and PR	Arrow Energy
✓	..	3	Options and PR	Boral
..	..	..	..	ConnectEast Group[f]
..	✓	5	Cash	Metcash[g]
✓	..	3–5	PR	Suncorp-Metway
✓	✓	3	PR	Transurban Group
✓	✓	3–4	PR	WorleyParsons

[d] Alumina has two hurdles, weighted 50% each. [e] Only CEO is paid with options. [f] ConnectEast did not have a long-term incentive scheme in 2008, although it proposed a new scheme in 2009 with short-term, medium-term and long-term incentives. [g] Information relates to Metcash's 'long-term retention payments' that applies to executive directors and some members of the executive team. .. Not applicable.

Sources: Company annual reports.

In contrast to short-term incentive payments, most remuneration reports set out the level of payment of long-term incentive payments against the performance hurdle. For example, AMP noted that if its TSR ranking were below the 50th percentile of the comparator group, then none of the performance rights would vest. If ranking were at the 50th percentile, then 50 per cent would vest, if between the 50th and 75th percentiles then vesting is 50 per cent plus 2 per cent for each percentile, with all rights vesting at the 75th percentile or greater. The details of relative TSR hurdles were generally well disclosed, although this was not consistently the case for other types of hurdle.

In general, vesting periods for long-term incentives were typically around three years, with some companies offering phased vesting periods (for example, St. George Bank offered options and performance rights in three tranches, with a third of the incentives vesting after two years, a further third after three years, and the remainder after four). Some also allow 'retesting' of performance hurdles if these are not met at the first opportunity (for example, Westpac allows performance hurdles to be retested four and five years after the grant date).

Box 7.7 **Short- and long-term incentives in 2009**

Not all companies had produced their annual reports for 2009. Consequently, tables 7.4–7.7 refer to annual reports for 2008. However, a sufficient number of reports have been released to give a broad indication of practices in executive remuneration.

In general, remuneration practices in 2009 were consistent with those in 2008. One common theme reinforced in 2009 was the increasing use of deferred short-term incentive schemes, with several companies introducing new plans or extending existing ones. Revisions to long-term incentive schemes also featured in 2009, with more companies linking pay to relative TSR performance (although at least one company moved away from this hurdle).

- **Commonwealth Bank** has revised its long-term incentive scheme for 2009-10. The vesting period will extend from three years to four, with relative TSR replacing net profit after tax as a performance hurdle. The bank's TSR will be measured against the largest 20 ASX-listed companies (excluding materials and energy companies).
- **Telstra** moved from an absolute, to relative, TSR hurdle in 2009, with performance assessed against an international peer group of telecommunications companies.
- Following a majority 'no' vote on its remuneration report in 2008, **Wesfarmers** cut short-term incentive payments in 2009. The board exercised its discretion to withhold payments eligible under individual performance targets. The company will introduce deferral of short-term incentives in 2010.
- **Macquarie Group** increased the proportion of its profit share scheme that would be retained in deferred shares and Macquarie-managed funds.
- **Newcrest Mining** increased the proportion of executive remuneration 'at risk', with changes to both its short- and long-term incentive schemes. The company replaced its short-term incentive schemes with a deferred share plan. Newcrest replaced its relative TSR hurdle for long-term incentives with a mix of targets (reserves growth, comparative cost position and return on capital employed).
- Executives at **Boral** did not realise any benefits from short- or long-term incentive plans in 2009. The company will restructure CEO remuneration to place a greater emphasis on long-term incentives over base pay and short-term incentives.
- **ConnectEast** proposed new medium- and long-term incentive plans, focussed on performance over 2–3 and 3–5 years respectively. Medium-term incentives will be linked to internal performance targets, while long-term incentives will adopt a relative TSR hurdle.
- **WorleyParsons** introduced a deferral component to its short-term incentive scheme, with some bonuses to senior executives paid in shares. For these deferred shares, WorleyParsons will review performance again one year after granting. The shares may be forfeited if performance is not considered satisfactory.

How well has incentive pay worked?

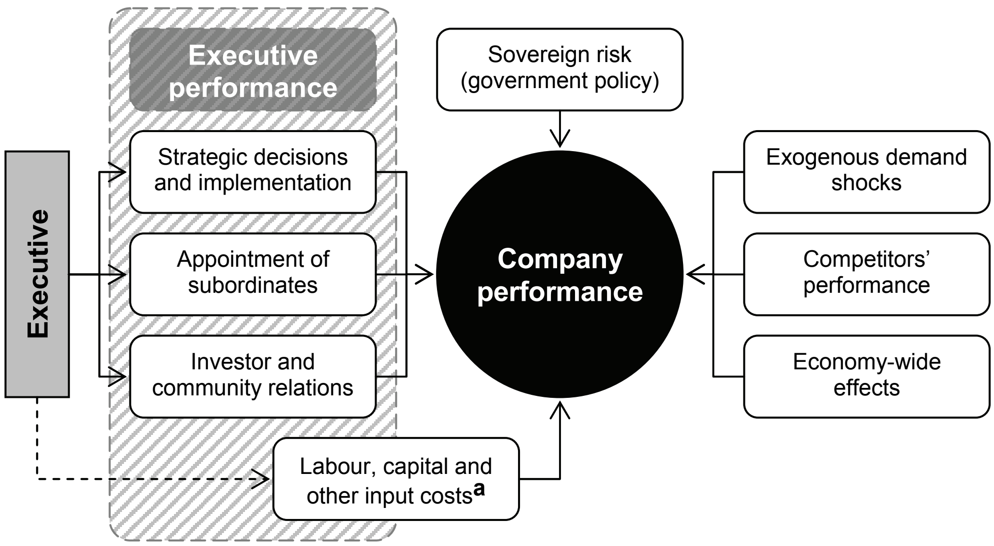
'Aligning interests' is distinct from saying that an executive's pay should be entirely dependent on the company's performance (as an ordinary shareholder's investment in the company might be). Executives are not exclusively responsible for a company's performance, with other external factors likely to have an impact on performance as well (figure 7.2). Moreover, executives will be expected to exert effort and perform on a day-to-day basis. For this they will require remuneration, usually in the form of fixed pay. Incentive pay, additional to this, can be used to drive executives' actions in the job (and partly substitute for the monitoring of them, which would likely be more costly).

As noted earlier, short-term and long-term hurdles commonly target different aspects of performance. Short-term incentives are generally focused on particular executive actions, whereas long-term incentives tend to align more closely with overall company performance.

From the executives' perspective

In its 2008 annual report, the Commonwealth Bank indicated that research had shown short-term incentive payments to be 'the most effective driver of performance' (Commonwealth Bank 2008, p. 59). Consequently, the bank removed long-term incentives for all but the most senior executives. However, in 2009 the Commonwealth Bank increased the proportion of senior executive's remuneration tied to long-term incentives, arguing that this would 'encourage long-term

Figure 7.2 **Influences on executive and company performance**



[a] These are areas that an executive may be able to influence, but will not (likely) have full control over.

shareholder value creation' (Commonwealth Bank 2009, p. 68). Changes in remuneration practices over time are common, partly reflecting the challenges of calibrating the relative balance between short- and long-term incentives.

The benefits of short-term incentives are sometimes too readily dismissed. Where short-term incentives are tied to pursuing specific strategies or completing specific projects, the tangibility of outcomes could be expected to help focus the performance of executives better than, for example, targeting share price growth over a period of several years.

Moreover, short-term hurdles can (and arguably should) be consistent with long-term performance, where performance is assessed against implementation of new strategies that are intended to drive company growth over subsequent years. Even where short-term incentives focus on immediate performance, long-term outcomes can still be promoted through pay structures. The use by some companies of deferred shares as a short-term incentive (as noted earlier) is consistent with this approach.

Compared with short-term incentives, some participants claimed that executives perceive long-term incentives as akin to a 'lottery' (Stern Stewart and Co., sub. 53; Australian Bankers' Association, sub. 70; KPMG, trans., p. 393). A measure of performance such as relative TSR depends on many factors beyond the control of an executive. While this does not make such payments worthless — the value is the probability of meeting the hurdle multiplied by the price of the instrument — it does mean that their incentive properties are likely to be weakened. Moreover, the value executives place on those instruments is likely to be lower than the accounting value recorded by the company (chapter 4). This effect is likely to be reinforced by the inability of executives to insulate themselves against company-specific risk (unlike ordinary investors who can spread their wealth across a diverse portfolio of investments).

However, there are considerations in the other direction. While ordinary investors are 'price takers', executives — because they are responsible for managing the company — must have some influence on the share price (Yang and Chance 2008). In some cases, executives might value equity-based payments at a level greater than the cost to the company. However, this would seem to assume a particularly high level of executive influence over the company's performance and its share price.

From the shareholders' perspective

While executives (and analysts) have expressed doubts about the incentive properties of long-term performance hurdles, shareholder groups appear more enthusiastic. In particular, the Australian Shareholders' Association (ASA, sub. 54) and ACSI (sub. 71) both supported relative TSR as an appropriate benchmark for long-term performance. Two key reasons are that:

- performance hurdles that are linked to market performance (that is, measures such as TSR or relative TSR) should mean that executives are focused on delivering value to shareholders over time
- market-based performance hurdles are relatively transparent, limiting the scope for executives to obtain remuneration that may be seen as unjustified.

However, if the 'lottery' argument has some basis, as is likely, the incentive effects of such a remuneration structure will be weak. Moreover, companies will have to pay more to offset the greater risk to the executive.

The second reason — transparency — is more compelling. Because short-term incentive payments are often granted subject to targets for key performance indicators or other internal benchmarks that might not be disclosed, it is difficult for those outside the company (in particular, shareholders) to verify the performance claims made or understand the executive's performance. The appeal of hurdles such as TSR and relative TSR is that they can be objectively measured. However, transparency is of little benefit if the incentive properties of the hurdle are weak.

Consequently, although short-term incentive payments may be effective drivers of executive performance, shareholders may be less supportive of their use because executive performance against them cannot be directly observed. For example, the ASA urged boards to 'be sparing in the use of short-term incentives, particularly in the case of CEOs, and ensure that at least half of the rewards under these schemes are linked to pre-set, quantifiable financial hurdles' (sub. 54, p. 20).

A balancing act

Boards must balance shareholders' desire for transparency, executives' preference for (incentive) payments based on hurdles that they can significantly (but sustainably) influence the probability of achieving, and the objectives of the company itself.

In practice, many companies adopt a mix of hurdles. With regard to long-term incentives, the ASA (sub. 54) suggested that companies should link payments to at least two different hurdles — one closely aligned with shareholder interests (relative TSR), the other reflecting earnings growth (for instance, earnings per share). ACSI (sub. 71) also advocated a mix of indicators, in particular combining both relative and absolute measures of performance. However, the Australian Bankers'

Association (sub. 70) indicated that split hurdles are not perfect, and that no selection of targets can completely replace the need for board judgment.

Where boards explain what companies' goals are, and how chosen remuneration structures are designed to achieve them, this may provide comfort to shareholders — even if the details of selected hurdles cannot be disclosed up front for legitimate reasons of commerciality.

Risk-taking and 'short termism'

Central to community concern around the global financial crisis is a view that remuneration structures in the financial sector encouraged 'excessive' risk-taking (chapter 1). In the case of major financial institutions, such conduct can pose a threat for other institutions (as counterparties to transactions) or consumers and businesses (who, for example, rely on those institutions to hold deposits or provide access to credit).

In May and September 2009, the Australian Prudential Regulation Authority (APRA) released proposals to reform the regulatory arrangements surrounding remuneration within the financial sector (box 5.4 in chapter 5). It noted that 'sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets for remuneration purposes' (APRA 2009c, p. 11). APRA argued that regulated entities (authorised deposit taking institutions as well as general and life insurers) should adopt pay structures that supported prudent risk management. This is broadly consistent with views overseas on risk-taking, although other proposals have been contemplated (box 7.8).

In terms of different equity-based payments, CGI Glass Lewis and Guerdon Associates suggested that options can encourage risk-taking, while performance rights can make the executive more risk averse than the typical long-term, diversified investor (sub. 80). Large equity holdings can also encourage risk aversion on the part of executives, where a significant portion of their wealth is held in the company's shares. A further concern is likely to be how performance hurdles are used, and whether these are able to ensure that an executive is appropriately concentrated on the company's performance over time.

The problems that APRA identified within the financial sector might also be relevant for executive remuneration practices elsewhere in the economy. Regnan argued that sustainability in a company's growth was often ignored, in part because:

> … executives make decisions whose effects in many cases outlast their tenure and we believe that alignment of executive rewards to better reflect this reality would strengthen Australia's governance practice.

> The asymmetry, whereby executives can receive entrepreneurial levels of reward without commensurate personal exposure to financial downside, provides a significant incentive to executives for delivering short-term results, even where these are at the expense of the long-term health of the enterprise or wealth of its owners. (sub. 72, p. 1)

The challenge of 'short termism' is closely associated with the assessment of risk. Adverse outcomes might take years to appear, while the gains from pursuing strategies that generate the risks of such adverse outcomes are realised in the short term. Unless performance hurdles have a sufficiently long-term focus, executives might be rewarded for adopting risky strategies, without facing consequences once problems emerge. It is this potential that APRA's guidelines attempt to mitigate.

Box 7.8 **Different approaches to regulating risk-taking and remuneration**

Leading up to a September 2009 G-20 summit, policymakers around the world expressed concerns about the role of short-term bonuses in promoting 'excessive' risk-taking in the financial sector, and considered a number of policy ideas that might be enacted internationally.

- The French Government argued bankers' bonuses should be curtailed by restricting the total amount of money financial institutions set aside to pay bonuses (as a proportion of operating income) and/or by setting a fixed cap on the amount any individual financial sector employee can receive as a bonus (Hall 2009). These approaches would risk significant adverse consequences, with a likely restructuring of remuneration packages in favour of fixed pay over performance-based pay, and a potential for at least some bankers to be driven out of the financial sector into other jobs that are not subject to such controls on pay.
- G-20 finance ministers agreed that payment of bonuses should be deferred, with consideration given to replacing upfront cash payments with stock options (BBC News 2009). In principle, options can create alignment between remuneration and long-term performance, since the recipient only benefits if the share price on the underlying security increases before expiry. However, one consequence of this is that options can *encourage* risk-taking, since stable share price performance is not strongly rewarded, even if this were the consequence of a 'safe' level of risk-taking.
- Lord Adair Turner, the head of the UK Financial Services Authority, suggested that one way to reduce bonuses in the financial sector would be to levy a tax on transactions taken by financial institutions (Monaghan 2009). The French Government has also suggested such a tax could be used to insure retail bank deposits (Hall 2009). The effect of such a tax would be to reduce banks' profits, thereby reducing the potential pool from which bonuses (and remuneration in general) could be paid. However, this would also reduce shareholders' returns, and would appear to be a needlessly blunt approach for reducing 'excessive' risk-taking.

However, risk has two sides — a positive when the risk pays off, and a negative when it does not. There is by definition no way of knowing which outcome (either positive or negative) will eventuate until it occurs. Efforts to limit the negative outcomes from risk will inevitably curtail its potential for positive returns as well. This might not be in shareholders' (or indeed the community's) interests. Specifically, since higher returns result — on average — from higher levels of risk, restricting risk will inevitably reduce returns to shareholders.

There are reasons why APRA's guidelines would not all be appropriate on an economy-wide scale. First, the majority (in quantity) of APRA-regulated institutions are not listed on the ASX. Hence APRA's specific financial sector guidance is justified on the basis that many of the remuneration guidelines relevant to public companies (chapter 5) do not apply. Moreover, many of the people likely to be covered by the APRA guidelines are non-executive employees — including market traders and sales personnel.

Second, most companies and industries do not pose the same systemic risks to the broader economy as the financial sector. For example, the collapse of a bank can threaten counterparties, causing consumers to panic and withdraw funds from, and place pressure on, other institutions. These broader consequences may not ordinarily be accounted for by the boards of particular institutions.

For most other companies, there are probably few (if any) such 'contagion' effects. The costs of 'excessive' risk-taking are borne mainly by the company and its stakeholders (including employees). Given the essentially internalised nature of this cost, boards have a strong incentive to account for risk in structuring remuneration packages. This could be achieved by adopting a mix of short-term and long-term incentives, with performance hurdles being tested over different time spans. A related mechanism is for companies to defer payments to executives subject to validation of performance after the deferral period (potentially months or years). (However, consistent with the earlier discussion on short- and long-term incentives, APRA (2009c) also warns that excessively long deferral periods can significantly weaken performance incentives.)

Finally, what constitutes 'prudent' risk can vary between industries, between companies and over time. In some circumstances — for example, in the resources or technology sectors — risk-taking is highly desirable. Efforts to curtail risk might limit innovation in many markets (or indeed, in the development of entirely new markets). Shareholders in these cases might expect executives to take substantial risks, and remuneration structures should be expected to reflect this. (Further, risk-averse shareholders can mitigate their own exposure to risk by diversifying their portfolios.)

Of course, companies might not always structure remuneration packages appropriately. As CRA Plan Managers noted:

> Less volatile businesses may adopt performance aggressive remuneration structures, but this would almost certainly lead to a mismatch between their business strategy and their remuneration strategy. (sub. 103, p. 8)

An aggressive performance remuneration structure for a less volatile business might contribute to 'excessive' risk-taking. However, it is unclear how such imprudence might be identified by external parties before problems emerge. In the absence of external costs, boards are likely to be best placed to make assessments of appropriate risk-taking for their companies.

Can complexity be reduced?

Both the forms of pay (particularly equity-based pay) and the use of performance hurdles have proven to be complicated in practice, which can lead to misunderstanding and mistrust. This factors in the diversity of views on the link between pay and performance (box 7.9). For example, some inquiry participants questioned why executives should be paid any differently from other workers (for example, Ken Thompson, sub. 19; Kenneth Park, sub. 21).

There also appears to be unease amongst some directors. In a speech to the AICD, former Wesfarmers CEO Trevor Eastwood argued for a return to a predominantly fixed pay structure, to improve transparency:

> I think the idea is quite radical: to basically go back to fixed remuneration … No incentives, no share schemes and if you want shares, buy them … Companies will then be able to judge more precisely salary increases against average earnings, inflation and long-term changes to a company's financial reckoning. They and the shareholders will be able to easily understand the consequences of the changes and remuneration reports will be able to be brief and understood. (cited in Sharp 2009a, p. 3)

As discussed in chapter 4, complexity — whether it arises from the form of pay (equity), the conditions imposed (performance hurdles), or the interaction of the two — may 'camouflage' remuneration levels and drivers, while not necessarily generating stronger incentives for executives to perform in the interests of shareholders. Greater simplicity could have advantages in both respects.

Charles Macek broadly agreed with Eastwood's sentiments, supporting (in principle) a simple system of fixed pay coupled with discretionary bonuses. However, he believed the approach would be impractical because:

> … such a back to the future approach requires trust. Today that trust of Boards by shareholders does not exist. Neither, I suspect, is there sufficient trust of Boards by

management to exercise such discretion in an objective and fair manner. (sub. 55, p. 12)

Trust is clearly a crucial factor. Any principal–agent relationship will break down where trust is lacking. In the case of the relationship between shareholders and boards on the one hand, and boards and executives on the other hand, there will always be informational asymmetries. Trust can be promoted by transparency, although promoting transparency may jeopardise other desirable objectives.

For example, one of the arguments in favour of long-term incentive payments, where performance is assessed against such metrics as relative TSR, is that the reported performance outcomes can be easily verified. Yet, as noted earlier, if the incentive properties of such payments are weak, the emphasis on transparency may cause the effect on performance to be missed. Shareholders might not be aware of this tradeoff. By the same token, poor disclosure might not always be justified by commercial sensitivity (chapter 8).

Box 7.9 **The *Harvard Business Review* debates executive pay**

In the middle of 2009, several academics, executives and remuneration industry practitioners contributed to an online debate on executive remuneration, hosted by the *Harvard Business Review*. A summary of their views on the link between pay and performance is offered here.

- Kaplan (2009) found executive pay to be strongly correlated with performance. This contrasts with Delves (2009), who claimed that many board members believe executive pay is too high and that the link with performance is not sufficiently strong.
- Sheehan (2009) argued that executive remuneration has caused ‘excessive’ risk-taking by companies.
- Narayanan (2009) emphasised that pay structure rather than quantum is important. Fernández-Aráoz (2009) contended that the question of pay levels is less important than employing the right CEO and other senior executives in the first place.
- Bebchuk and Fried (2009) observed that although equity-based pay has the potential to drive performance, such arrangements are often poorly structured, allowing executives to capitalise on short-term (temporary) gains in the share price. To counter this, they proposed staggering the payment of vested equity. Landry (2009) argued this would be unnecessarily complex, and boards would not properly adopt such a scheme. He favoured deferred shares as a simple mechanism for aligning an executives’ interests with those of the company over the long term.
- Martin (2009) warned against linking pay to share price performance because executives have little ability to directly influence the share price (legitimately). By contrast, metrics such as EPS or market share reflect areas over which executives can exert greater control. Moreover, performance improvements in these areas will still lead to creation of shareholder value.

'Vanilla' remuneration structures pose risks

CGI Glass Lewis and Guerdon Associates warned that some boards had felt obliged to adopt performance measures that 'are ineffective and inappropriate in some circumstances but which are utilised because they are prescribed by various governance and stakeholder groups' (sub. 80, p. 97). Put another way, boards feared that if they failed to adopt the performance measures set out by those groups, then their remuneration reports would be voted against.

Of course, what companies may perceive as shareholders 'not listening' could in fact be shareholders simply disagreeing with the remuneration structure being proposed. In these circumstances, even if companies believed their remuneration approach were justified, they might not have explained their reasons sufficiently well. (This may be more likely where companies pursue a remuneration approach different from peers, since shareholders may not be familiar with what is proposed.)

Nevertheless, it is conceivable that shareholders (and groups acting on their behalf) may prefer consistency across companies, and this could translate into pressure on companies to adopt specified forms of pay and performance hurdles. Standardised approaches to pay structures can be easier to understand and facilitate cross-company comparisons. Such 'rules of thumb' are particularly likely to have appeal where the portfolios held by investors are quite diverse.

However, uniformity can have downsides. The Business Council of Australia observed:

> If variable pay is to be closely aligned to real drivers of company performance over time, a greater diversity and indeed complexity of measures and targets is required within and across companies. This should not be surprising. Large companies are complex as are the vast majority of contracts that relate to their operation. (sub. 101, p. 14)

That companies are different is generally acknowledged — indeed, it is a fundamental principle behind the ASX Corporate Governance Council's 'if not, why not' disclosure regime (chapter 8). Consequently, 'prescribed' or standardised pay structures might not be helpful in promoting improved performance (in much the same way that imposing standardised investment strategies across all companies would not be appropriate), yet could also be driving unnecessary complexity.

If every company is different, how are shareholders to know whether any individual company has selected appropriate remuneration structures? As CGI Glass Lewis and Guerdon Associates argued:

> In most instances it is probably better to provide reward in a mix of cash, share rights, share options and shares to overcome much of the agency costs. But there is no 'right'

> mix. It will depend on the company's strategy, opportunity, cash flow, capital structure and requirements, and its stage of maturity. The implication is that over time the 'right' mix will change.
>
> In short, the mix is somewhat of an art requiring business judgment of the stage that the organisation is at. Given the complexities, the board is in the best place to exercise this judgment because it has the requisite inside knowledge of the business. (sub. 80, p. 26)

Whether or not complex performance hurdles represent over engineering (either by boards directly or in response to shareholder pressure) remains contentious. Perversely, while the complexity of some remuneration packages may have been intended to influence executive performance with greater precision, too narrow a focus on particular incentives might have led to unanticipated results in other areas or larger than expected payments. Boards are already likely to be aware of such possibilities, but they might find benefit in explaining to shareholders how they avoid these outcomes. This is considered further in chapter 11.

Additionally, requiring executives merely to hold shares in the company for an extended period of time might achieve similar performance outcomes to more complex structures (box 7.10). Notably, some companies have begun to offer deferred shares as part of their short-term incentive plans in place of cash bonuses, although they still use options and performance rights for their long-term incentives.

7.2 Non-recourse loans

Particular aspects of remuneration might be sufficiently problematic to justify policy interventions. Three areas identified in the terms of reference for this inquiry are considered in this and subsequent sections.

Some companies grant executives access to loans as a benefit of their employment. The terms of reference for this inquiry request that the Commission specifically consider 'the issue of non-recourse loans used as part of executive remuneration'.

What are non-recourse loans?

A 'non-recourse' (or, technically, 'limited recourse') loan is secured only by the asset purchased (the shares), with the lender having no claim to the borrower's other assets in the event of default. (This contrasts with 'full recourse' loans, where the borrower is fully liable to repay the loan.) Non-recourse loans are typically offered to executives on an interest-free basis, with dividends earned from the shares used to pay off the loan. Consequently, the shares come at no monetary cost to the

Box 7.10 **Promoting alignment and simplicity: deferred share schemes**

Remuneration structures continue to evolve. One feature demanded by shareholders (for example, ASA, sub. 54), and now adopted by some companies (tables 7.4 and 7.5) is to link short-term incentive payments to performance over a longer timeframe. This is commonly achieved through the use of deferred share schemes.

While long-term incentives often rely on applying performance hurdles over a period of years to determine if and when payments should be made, a deferred share scheme might only be contingent on meeting a performance hurdle in the short term, then requiring executives to retain the granted shares for a defined period. The effect is to link a portion of executives' wealth to the company's ongoing performance, beyond the assessment of performance at the grant date. (Holding locks applied to options and performance rights post-vesting have similar benefits.) Deferred share schemes can also act as 'retention' payments, such that executives who depart a company before the conclusion of the deferral period risk forfeiting their shares.

Deferred share schemes provide a simpler form of remuneration than options or performance rights. Nevertheless, such schemes have considerable potential to align the interests of executives with those of the company (and shareholders).

The effectiveness of deferred share schemes as an incentive for driving company performance will depend on the appropriateness of the initial hurdle (if any), and the degree to which any individual executive believes he or she can influence shareholder value. Deferred share schemes might also contribute to executives' risk aversion (which may or may not be desirable, depending on the company's risk profile), particularly if a large portion of their wealth is tied up in such schemes.

executive, although the loan must be paid in full before the executive can exercise rights over the shares (for example, to sell them). Non-recourse loans can also be available for other employees, not just executives, often as part of an employee share scheme (AICD 2008b).

Participants have indicated that non-recourse loans are not very common (for example, ASA, sub. 54; Chartered Secretaries Australia, sub. 57; Macquarie Group, sub. 52). The Australian Human Resources Institute, in a survey of its members on executive remuneration in April 2009, reported that only 4 per cent of companies offered non-recourse loans to executives, with 2 per cent of executives receiving such loans (based on responses from 150 specialist practitioners within ASX200 companies) (sub. 49).

While Australia does not directly regulate the use of non-recourse loans (although disclosure is required), some countries have chosen to restrict the ability of companies to lend money to executives (box 7.11).

Box 7.11 Regulation of loans to executives and directors

Australia

Non-recourse loans are primarily regulated in Australia through requirements to disclose remuneration of key management personnel in the remuneration report (section 300A of the Corporations Act and the Australian Accounting Standards Board Standard 124). If such loans are significant, they might also be regulated indirectly through:

- section 260A of the Corporations Act, which states that a company can only offer financial assistance to a person to buy shares in the company if the assistance does not materially prejudice the interests of the company, or under approval of shareholders by special resolution (an exemption applies if the financial assistance is provided through a shareholder-approved employee share ownership scheme)
- ASX listing rule 7.1, which requires prior shareholder approval if total shares issued in the past 12 months exceeds 15 per cent of total shares on issue
- ASX listing rule 3.1, which requires that if an entity becomes aware of information that a reasonable person would expect to have an effect on the entity's securities, the entity must immediately disclose that information to the ASX.

Overseas

In the United States, the Sarbanes-Oxley Act 2002 prohibits US companies from lending money to executives. Similarly, companies in France, Sweden and Denmark are strictly prohibited from making loans to executives.

Some European countries allow loans to be made to directors but only on approval of the supervisory board. (Some European countries require companies to have two boards — one, the management board, comprising only executive directors; the other, the supervisory board, comprising only non-executive directors.)

In the United Kingdom, companies are allowed to extend loans to *executives*, without disclosure requirements, although they are prohibited from extending loans to *directors* (including executive directors) without shareholder approval.

Incentive misalignment?

In principle, non-recourse loans could be expected to facilitate alignment between executives and shareholders, because they are used to purchase shares — giving executives 'skin in the game' without requiring a direct monetary outlay on their part. The Investment and Financial Services Association considered that equity participation should not involve non-recourse loans (IFSA 2009). Similarly, ASA (2009) guidelines state that there should be no company loans associated with long-term incentives as this decouples incentives and is an inappropriate use of shareholders' funds. By contrast, although ACSI (2009a) does not support loans to executives on a non-commercial basis to purchase shares, it will support non-recourse loans where, if the shares acquired under the arrangement are forfeited, the company can sell the shares to recoup some of what is owed by the executive. ACSI also notes that using newly issued shares in such schemes can minimise potential cash losses to a company.

A common argument against non-recourse loans is that they limit the downside risk in executives' remuneration. For example, the AICD (2008c) contends that non-recourse loans can weaken the link between remuneration and performance by diluting the 'at risk' aspect of share ownership, as the wealth of the executive is not threatened if the company's share price falls. If the share price declines significantly, the executive can simply forfeit the shares. The company then bears the risk of funding any shortfall between the value of the shares and the outstanding loan amount.

In designing incentive pay, a fundamental principle is that boards should seek to align the risk profiles of executives with those of the companies they work for (section 7.1). In many cases, particularly for mature companies, an objective in designing remuneration policies might be to limit risk-taking. Non-recourse loans are unlikely to be appropriate for these businesses. But for other companies, particularly startup ventures or failing enterprises (where boards need to attract new talent to try and turn the company around), risk-taking could be essential. In these circumstances, boards might consider that structuring remuneration to limit downside risk is appropriate (especially for a risk-averse executive who might otherwise require higher remuneration in other forms to offset the risk). Non-recourse loans could be a useful instrument for achieving this compared to other mechanisms (box 7.12).

Nevertheless, non-recourse loans create uncertainty for companies in the event of share price declines. While a share grant involves a known cost, a loan might be fully repaid, or it might not be. The potential cost to the company will depend on the willingness of the executive to forfeit shares and the extent of any share price decline, as well as any interest costs. (Having said this, the maximum potential cost of an abandoned loan is known, since the share price cannot fall below zero.) Boards (and shareholders) may prefer pay structures that offer more transparent costs to the company.

There are alternative forms of remuneration that may be able to produce similar incentive effects to non-recourse loans — for example, a combination of fixed pay with shares or options. However, such approaches might expose the company to higher costs for successful performance. For example, as an option is worth less

Box 7.12 Substitutes for non-recourse loans

The effect of lending executives money to acquire shares should be contrasted with simply granting them shares outright. In the case of a direct grant, companies (and their shareholders, in the case of newly issued equity) face a clear cost that is not intended to be recovered. Even if a non-recourse loan is abandoned by an executive, the company will still be able to sell the secured shares and recover some value (unless the share price falls to nil) — the net cost to the company per share will be smaller than if they had granted the shares to the executive. (However, granting shares and lending money to buy shares are not perfect substitutes. Hence the same quantity of shares might not be offered.)

In this context, the downside risk to the company is *reduced* through lending rather than granting. On the upside, the company enjoys the benefit of an executive whose interests are aligned with those of the company and shareholders (they now own shares, which they want to see increase in value) without having faced a significant cost (aside perhaps from the interest forgone on the loan). The upside potential to the executive might be constrained relative to a share grant, depending on the conditions of vesting and whether dividends are payable to the executive.

Non-recourse loans do expose executives to less downside risk than full recourse loans (where a company could recover the full value of the loan from *any* of an executive's assets). However, it is unlikely (at least in all cases) that full recourse loans would be offered in the absence of non-recourse loans. The different risk implications for both the executive and the company might mean the two types of loan are not direct substitutes.

than the underlying share, more options would need to be granted than the quantity of shares obtainable through the loan. As the share price increases above the option's exercise price, the cost to the company if the option is exercised also increases. In this case, the uncertainty associated with costs if the share price declines is replaced by uncertainty about the costs of remuneration where the share price increases — the only difference being that the share price, and therefore the maximum potential cost to the company, faces no limit on the upside. (Of course, since the share price reflects the company's performance, a higher share price is a desirable outcome — although it might result in a higher cost, in terms of acquiring equity to remunerate executives.)

Policy implications?

Some inquiry participants considered the current regulation of non-recourse loans to be sufficient. For example, Chartered Secretaries Australia observed that non-recourse loans 'are transparent and required to be reported to shareholders via the remuneration report' (sub. 57, p. 42). The AICD (sub. 59) and the Australian

Bankers' Association (sub. 70) observed that it is the role of boards to assess the appropriateness of non-recourse loans.

Others took the view that non-recourse loans should be prohibited. For example, the Finance Sector Union claimed that 'allowing these loans for executives who can directly affect share price misaligns shareholder and executive interest' (sub. 39, p. 7). The ASA noted it 'may be appropriate to regulate to prevent such loans being made' (sub. 54, p. 21).

On balance, it appears hard to justify the banning of non-recourse loans. The perceived risks associated with such loans appear overstated, particularly when compared to some other commonly used instruments. Further, although non-recourse loans can impose costs, each company would need to weigh these against the potential benefits. While many companies are likely to find non-recourse loans unsuited to their circumstances, such loans could be an effective instrument for aligning risk profiles for some companies. Nevertheless, it remains important, as with other vehicles for incentive alignment, that non-recourse loans and the contingent liability being incurred by companies are transparently disclosed to shareholders.

7.3 Hedging of incentive payments

Hedging involves the use of financial instruments to reduce financial risk. The terms of reference ask the Commission to consider 'the use of hedging over incentive remuneration', paying regard to the implications for the alignment of interests between executives, boards, shareholders and the wider community.

Equity-based payments and performance hurdles are designed to align the executive's interests with shareholders by linking pay to performance (section 7.1). Hedging of incentive payments using financial products (for example, 'put' options, which pay off when share prices fall) can reduce risk and enable executives to transform 'at risk' pay to fixed pay (at a cost). This undermines the intention of such schemes and breaks the link to performance. There are, however, other possible actions an executive could take to mitigate exposure to company-specific risk (box 7.13).

At any point in time, equity remuneration for executives can take three different forms:

- unvested shares or options (that is, before performance hurdles have been achieved or service conditions fulfilled)

- vested but subject to a holding period (that is, the executive has met any hurdles, but cannot sell the shares yet)
- vested, with the executive able to sell the shares.

Box 7.13 **Hedging in other guises**

A common way for investors to hedge against company-specific risk is to invest in a diverse portfolio of stock (or other assets). Similarly, executives could invest their private wealth in a selection of companies, complementing shareholdings in their own companies (acquired as a result of equity-based remuneration). Declines in the value of employment-related shareholdings might be offset by gains in other investments. While this is not generally a concern, such diversification could cause executives to take greater risks than intended by the design of their remuneration packages.

The risk aversion of executives could also act in a contrary way, such that executives' own behaviour becomes a *de facto* form of hedging. For example, in order to protect the value of their shareholdings in the company, executives might reject riskier long-term projects that offer the potential (but not a guarantee) to deliver strong growth opportunities. Pursuing such projects could be in a company's (and shareholders') interests, but if executives believe their 'at risk' pay is too risky, they might choose less risky projects with more certain payoffs to limit the company-specific risks they face.

Although there are some concerns about hedging all of these forms of equity, concerns principally relate to *unvested* equity. There is currently some regulation relating to hedging of incentive payments, and various corporate governance guidelines also offer comments on the practice (box 7.14).

Share trading policies

In 2006, concerns were raised in the media about executives hedging their long-term incentive remuneration, the lack of company awareness of this practice and the absence of policies for dealing with it. Consequently, ACSI surveyed ASX200 companies on whether they had a policy that permitted hedging of such remuneration. Of the 120 respondents, 63 respondents (53 per cent) had a share trading policy covering hedging. Of those companies, none allowed hedging prior to vesting with about a third allowing hedging of *vested* equity (ACSI 2006).

In June 2007, the Corporations Act was amended to require that board policy on hedging be outlined in the remuneration report.

According to the ASX (2009a), while a high percentage of entities reported the existence of a trading policy (86 per cent) in 2007-08, fewer actually disclosed the terms (66 per cent). Many of the entities neither establishing nor disclosing a trading policy were listed on the ASX All Ordinaries index (the top 500 listed entities by market capitalisation).

Box 7.14 **Regulation and guidance on hedging of incentive payments**

The Corporations Act requires that if an executive's remuneration includes securities (shares or options), then the remuneration report should discuss board policy on the executive limiting exposure to risk (hedging) in relation to those securities and the mechanism to enforce the policy (section 300A(da)). This requirement is relatively recent (June 2007).

The ASX Corporate Governance Council's principles and recommendations discourage hedging of *unvested* entitlements, although they do not formally 'recommend' prohibiting hedging of incentive payments. Rather, it recommends that companies establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy (recommendation 3.2). In formulating a trading policy, it *suggests* companies consider prohibiting 'designated officers from entering into transactions in associated products that limit the economic risk of security holdings in the company over unvested entitlements' (ASX Corporate Governance Council 2007a, p. 23). The Council also recommends that companies publicly disclose the company's policy on hedging unvested entitlements under equity-based remuneration schemes (recommendation 8.3).

ACSI guidelines do not support executives hedging unvested share options, and encourage companies to disclose any policy on option hedging. Where a company permits directors and executives to hedge vested incentives, ACSI (2009a) considers the company should disclose such practice, by informing the market within two days of any hedging occurring.

The AICD observed that good corporate practice regarding executive option hedging includes:

- having a written and published policy on hedging of executive options or shares
- prohibiting hedging of unvested options or shares
- considering disclosing hedging of vested options or shares
- considering a mechanism for executives to report on hedging
- treating breaches of policy seriously (sub. 59, p. 62).

The ASA stated that 'boards must not permit executives to enter into arrangements (such as hedging) which reduce the risk elements essential to effective incentive schemes' (2009, p. 2).

Table 7.8 **Share trading policies in top 400 companies[a] in 2008 annual reports**

	Top 250 companies	*Companies ranked 251–400*
	% all companies	% all companies
Share trading policy exists:	80	40
• Rigorous and well defined policy	46	na
• Policy considered to be soft	33	na
Share trading policy does not exist[b]	20	60
Total	100	100

a By market capitalisation. **b** Includes those companies with a policy that contained no constraints on share trade that were not already required by law. **na** Not available.

Sources: WHK Horwath (2009a, 2009b).

WHK Horwath reported that 46 per cent of the top 250 companies by market capitalisation had a rigorous and well defined share trading policy in 2008, with 33 per cent considered to have a 'soft' policy (table 7.8). Larger companies weremore likely to have share trading policies, with only 40 per cent of mid-cap companies (those ranked 251–400) having a share trading policy.

Policy-relevant considerations

The Commission has not been presented with or otherwise found evidence that would enable an assessment of the extent to which hedging of unvested entitlements currently occurs. (Two companies reported they did not allow hedging of unvested equity — see Woolworths, sub. 91; BlueScope Steel, sub. 56.) The absence of current examples of the use of hedging might indicate that the disclosure regime and voluntary guidelines have been reasonably effective in stemming this practice. But it could also reflect the fact that hedging is an expensive practice for the executive, given that a third party would need to be compensated for assuming the risk the executive is trying to offload. Consequently, executives might have found little net benefit in hedging strategies, even where they are permitted.

Hedging of unvested equity

Although the practice appears to be uncommon, some participants considered that hedging of unvested equity should be prohibited in the Corporations Act (box 7.15).

As section 7.1 identified, performance-based pay is typically complex. These pay structures are specifically designed to expose executives to company-specific risk, to concentrate their efforts on driving company performance. But where executives can hedge against the company-specific risk, this clearly undermines the spirit (if not the letter) of their contract. Notwithstanding the complexity of remuneration arrangements, it is difficult to see how this benefits companies or shareholders.

Box 7.15 **Regulation of hedging of incentive payments — views from submissions**

The Finance Sector Union (sub. 39) and ACSI (subs. 71 and DD156) argued that hedging of unvested remuneration should be explicitly prohibited in the Corporations Act. However, the AICD warned that black letter law might not prove effective given the complexities of hedging arrangements, and the difficulties in legislating for all possible vesting conditions and trading limitations (sub. DD149).

Chartered Secretaries Australia (subs. 57, and DD147) and Macquarie Group (sub. 52) contended that executives should be permitted to hedge vested remuneration.

CGI Glass Lewis and Guerdon Associates considered it reasonable to allow hedging of vested equity without holding locks (sub. 80).

ACSI suggested the Corporations Act be amended to require disclosure of any hedging on vested equity:

> … where hedging of vested incentives arises, the company should inform the market about the transaction within 2 days of it occurring. (sub. 71, p. 16)

Chartered Secretaries Australia stated that directors' hedging of shares should be disclosed (sub. 57).

Although permitting an executive to hedge might reduce their exposure to risk, there are other mechanisms that would achieve the same effect — for example, paying a higher proportion of base salary. Those alternatives would be more transparent to shareholders.

Hedging of vested equity

The arguments on whether executives should be able to hedge *vested* equity-based payments are less straightforward. Vested equity can either be subject to a holding requirement, or executives can be free to sell the equity if they choose.

Some participants argued that the application of holding locks should not prevent executives from hedging equity. For example, PricewaterhouseCoopers stated:

> If … the equity has vested, albeit it remains subject to a holding lock, we suggest that executives should be able to hedge this equity if they so desire. This is because once the equity has vested, the executive is absolutely entitled to it and, subject to trading restrictions and company policies, it becomes similar to other personal investments. (sub. DD138, p. 5)

However, boards usually impose holding requirements on vested equity to continue aligning the interests of executives with shareholders beyond the achievement of hurdles. To the extent that boards pursue this strategy, it would seem counterproductive to allow executives to hedge such equity (as with unvested equity).

Vested equity not subject to any holding period is in a different category. In this case, executives are *voluntarily* choosing to invest their wealth (past income) in the company (as they are free to sell the equity). To the extent that executives voluntarily choose to hold wealth in the companies that employ them, they should be able to hedge the risk involved (an option available to all shareholders in that company). Permitting such hedging might also lower remuneration costs for the company given portfolio risk premiums. Nonetheless, disclosure of such hedging can reduce any perception of insider trading.

7.4 Issues with termination payments

Termination payments, made when employment ceases, can comprise any or all of cash, accelerated vesting of equity, accrued leave entitlements and retirement benefits. The Commission has been asked to consider 'the role of, and regulatory regime governing, termination benefits', with specific reference to 'the role of accelerated equity vesting arrangements' (box 7.16).

A company might wish to make a termination payment for a range of reasons, including:

- rewarding an executive for long service or outstanding performance
- discouraging a departing executive from disclosing company 'secrets' to rivals or generating negative publicity about the company
- luring a talented executive from a secure job into a riskier position, such as turning around a faltering company (providing a minimum reward even if their efforts are not enough to save the company)
- ensuring a CEO or senior executive does not have an incentive to spoil merger negotiations or efforts to restructure the company that might result in him or her being deposed (Stapledon 2005).

Box 7.16 **Accelerated vesting of equity**

Boards currently have the discretion to waive vesting conditions related to performance-based payments, in order to allow executives to benefit from long-term incentive plans (or deferred short-term incentive plans) even if performance hurdles or time-based service requirements have not been met. This could be a cause for concern. The incentive properties of performance hurdles or service conditions are likely to be undermined by 'moving the goal posts', or at least a perception that this might occur. For instance, where an executive operates on the belief that vesting conditions will be relaxed upon departure, this could influence behaviour in a way that is undesirable for the company and its shareholders.

Nevertheless, there are cases where accelerated vesting might be justified. For example, where termination benefits are to be paid, accelerated vesting of existing entitlements might be a less costly mechanism for a company to pay a departing executive than cash. Moreover, granting an executive full rights to equity upon departure could act as a possible (although imperfect) signalling device to shareholders. If an executive retains shares voluntarily after departing, this might express confidence to the market about the strength of the company's position. If the executive chooses to sell the shares, then other shareholders might — in the absence of another plausible explanation — interpret this as a sign that the executive believes the company's performance will decline. (However such a signal would need to be interpreted cautiously, since an executive might sell shares for a number of reasons. For example, an executive who retires from a company might sell shares simply to finance his or her post-workforce lifestyle. This should not alarm shareholders.)

Accelerated vesting of at least a portion of equity might be required to cover tax obligations, depending on other policy changes (chapter 10).

Notwithstanding these legitimate purposes for termination payments, there is significant community and shareholder concern about 'golden handshakes', particularly where granted at a time of poor company performance. Shareholders typically perceive termination payments as remuneration for which companies derive little or no value — such payments, particularly when made on an *ex gratia* basis, are unlikely to influence future company performance. Contracted termination payments might also be problematic, as they could distort executives' performance incentives. In particular, since large guaranteed payments could allow for failure to be rewarded, executives might not be sufficiently motivated to perform. Reflecting these concerns, termination payments beyond a certain size involve greater shareholder scrutiny and approval than other forms of pay.

Recent and current arrangements

The size of termination payments in Australia is not directly limited by regulation. Rather, under the Corporations Act there is a requirement for *shareholder approval* in certain circumstances — in particular (in current legislation), where the proposed payment exceeds a prescribed multiple of the executive's remuneration package (averaged over the past three years). Companies are also required to disclose termination entitlements in the annual remuneration report. (Other aspects of the regulatory and governance framework pertaining to termination payments are outlined in box 7.17.)

As seeking shareholder approval can be costly (the time and resources required to call a general meeting of shareholders), and given the risk that a proposed termination payment might be rejected, there is an obvious incentive for companies to design termination payments that are less than the trigger specified in legislation. Given concerns that some termination payments in Australia have rewarded failure, the Australian Government introduced reforms to lower the threshold for shareholder approval from seven times total remuneration to an amount equivalent to one year's base salary, and broaden the scope of what is considered a 'termination payment'. The changes, detailed in box 7.18, took effect from November 2009.

Trends in termination payments

The AICD observed that in Australia there is a tendency to make lump sum termination payments. It noted that taxation laws — particularly that liability for unvested equity securities is triggered at termination — have resulted in a low incidence of deferring performance-based rewards past termination in Australia (sub. 59). (These taxation provisions are discussed in chapter 10.)

Some termination payments have been large. The Finance Sector Union provided a list of payments made to finance sector executives during their final year of employment (sub. 39). These data, derived primarily from Stapledon (2005), highlighted numerous termination payments between 1999 and 2004 that were many multiples of final year base salary. However, as Stapledon (2005) cautions, because many executives did not complete a full (financial) year's employment, this 'final year' salary was often an understatement. Moreover, some termination payments included other benefits, such as accrued leave entitlements. These factors tended to exaggerate the relative size of the reported termination payments, although many remained substantial.

Box 7.17 Regulation and guidance on termination payments

Australia

Under section 200B(1) of the Corporations Act, a company must not give a director or executive director retirement benefits, without shareholders' approval. There are some exceptions to this rule (set out in section 200F), including if the benefit:

- is given under an agreement made before 1991
- is given under order of a court
- is for breach of contract
- is less than the average of the executive's annual base salary over the past three years (as of November 2009; see box 7.18).

Section 200C of the Corporations Act also requires shareholder approval to provide a benefit to a person in connection with the transfer of the whole or any part of the undertaking or property of the company.

ASX listing rules also state:

- termination benefits cannot become payable to an officer of a company due to a change in shareholding or control of the company (listing rule 10.18)
- shareholder approval is required if total termination payments to officers exceed 5 per cent of the company's equity (listing rule 10.19).

Termination payments can also receive concessional tax treatment (chapter 10).

Guidance

ACSI encourages companies to disclose the potential value of a termination payout when disclosing the contractual arrangements (including termination conditions) for a senior executive (as per ASX listing rule 3.1). It also considers that boards should not pay out excessive and unreasonable termination payments in circumstances where the termination is a consequence of poor and inadequate performance (ACSI 2009a). The ASA considers that termination payments to 'failed' executives above statutory requirements or in lieu of notice are unacceptable (ASA 2009).

Overseas

In the United Kingdom, regulation in effect limits termination payments without shareholder approval to two years pay.

The European Commission adopted a recommendation in April 2009 that termination payments should not be paid where termination is due to poor performance and payments should not exceed two years of base pay (European Commission 2009a).

In the United States and the Netherlands, higher tax rates exist for termination payments above a certain threshold (chapter 10).

Box 7.18 **2009 changes to regulation of termination payments**

Amendments to the Corporations Act in respect of the threshold and scope for shareholder approval of termination payments entered into law on 23 November 2009. The changes apply only to contracts introduced or altered after this date, and:

- reduce the threshold for shareholder approval of termination payments from seven times total remuneration to one year's base salary (calculated on an average of the preceding three years)
- broaden the definition of 'termination benefit', capturing all payments at termination:
  - long-term incentives that vest after termination will not be considered termination benefits (although any move to accelerate the vesting of such incentives will be captured)
  - superannuation payments above statutory entitlements and any kind of pension will be counted as termination benefits (but a payment from a defined benefit superannuation scheme that was in place when the regulations commence will not)
- expand shareholder oversight of termination payments from company directors only to all key management personnel
- introduce a 'clawback' provision — any unauthorised termination benefits must be repaid immediately
- increase the maximum penalty that may be imposed on an individual for breach of the termination benefit requirements from $2750 to $19 800 (retaining the option of six months imprisonment), and on a company from $16 500 to $99 000.

Sources: Parliamentary Library (2009); Parliament of the Commonwealth of Australia (2009).

According to Hay Group data, there has been a decline in the relative magnitude of termination payments since 2003 (table 7.9). By 2008, the majority of termination payments made to CEOs and senior executives equalled between 10 and 15 months of fixed pay.

These findings are supported by research from ACSI, which shows that 13 of the companies comprising the ASX20 index set termination pay at less than (or equal to) one year's base salary (Byrne 2009). Further, an Australian Human Resources Institute survey of human resources managers reported that 92 per cent of companies have 12 months fixed pay or less on termination for their CEOs, and 98 per cent of companies have 12 months fixed pay or less for general executives (sub. 49).

Notwithstanding a trend decline on average, community angst may have been fuelled by some high profile cases where termination payments have appeared grossly excessive (box 7.19).

Table 7.9 **Termination payments by size, 2003 and 2008**

Proportion of all termination payments[a]

	2003		2008	
Months of fixed pay	*CEO*	*Senior exec.*	*CEO*	*Senior exec.*
Bona fide redundancy	%	%	%	%
Less than 3 months	0	0	0	0
3–9 months	0	18	20	20
10–15 months	36	73	60	60
16–21 months	28	0	10	20
22–27 months	18	9	10	0
Greater than 27 months	12	0	0	0
Total	100	100	100	100
Other				
Less than 3 months	10	10	0	0
3–9 months	0	0	27	45
10–15 months	20	70	73	55
16–21 months	30	10	0	0
22–27 months	20	10	0	0
Greater than 27 months	20	0	0	0
Total	100	100	100	100

[a] For CEOs and senior executives of organisations contributing to Hay Group databases.

Source: Hay Group (sub. 84, p. 15).

Box 7.19 **Reward for failure?**

A number of inquiry participants cited cases of executives receiving large termination payments despite poor performance. Regnan (sub. 72) and CGI Glass Lewis and Guerdon Associates (sub. 80) identified Oz Minerals, Transurban and AGL Energy as examples of companies where there were poor practices (chapter 1).

As noted, the Finance Sector Union presented a list of salary, termination payments and total payments for executive departures in the finance sector during their last year of employment. It considered that many of the examples relate to executives who were fired for poor performance. It also argued that most examples ‘demonstrate a disconnect between items declared as “termination” benefits, the salaries paid for a part year and the ultimate payment made for that financial year’ (sub. 39, p. 5).

Potentially compounding concerns over ‘rewards for failure’, companies do not always clearly articulate their reasons for making termination payments. RiskMetrics reviewed 25 CEO departures at ASX20 companies over the period 2000 to 2009, and found no cases where a CEO was disclosed as being terminated:

> The most information provided on the reasons for a CEO’s departure was by BHP Billiton in the case of Brian Gilbertson, whose January 2003 departure was described as a resignation following ‘irreconcilable differences’ with the board. In all other cases disclosure indicated that the departure was voluntary but despite this, in 11 cases, termination payments were made. (sub. 58, p. 12)

Anticipated versus realised pay

Participants have observed that reported termination payments do not necessarily equate with the actual amounts paid to departing executives. In some cases, the reported values are lower, with boards appearing to grant amounts larger than they are contractually obligated to pay.

RiskMetrics observed that in some cases 'amounts actually paid to a departing executive were substantially larger than indicated in prior disclosures' (sub. 58, p. 11). It noted:

> … Adelaide Bank in its 2005 annual report disclosed that the then-CEO, Barry Fitzpatrick, was entitled to one month's notice on termination, statutory entitlements and that the board had discretion to direct forfeiture of any unvested entitlements. On 19 July 2006, Adelaide Bank announced Fitzpatrick would retire in December 2006 and on 12 September 2006 that he would receive a 'retirement payment' of $8.3 million in addition to superannuation and statutory entitlements, representing 9 per cent of 2006 net profit. (sub. 58, p. 11)

Some commonly reported figures also might overstate the true size of termination payments. The AICD (2008a) observed that some concern with termination pay might arise from misunderstanding or misreporting of figures, with payments for unpaid leave, long service leave and superannuation sometimes labelled as 'termination pay'. John Colvin (CEO of the AICD) also cited examples of where actual termination payments were significantly below payments reported in the media:

- Suncorp-Metway CEO, John Mulcahy — who was reported to be leaving the company with a payout of $20 million. His termination payment was approximately $2 million, with the remainder of the quoted figure comprising his total salary over six years, leave entitlements and equity that would not vest or would be underwater (so would not be exercised).
- Telstra CEO, Sol Trujillo — who was reported to be leaving the company with a payout of $50 million. His termination payment was $3 million (equivalent to one year's base salary) (Colvin 2009).

The Australian Bankers' Association noted that disclosure of share-based payments can 'lead to large reported "termination payments" which are in fact merely retained bonuses not reported in the year to which they related' (sub. 70, p. 5).

Policy-relevant considerations

The perception that termination payments are used to reward failure has some basis. Indeed, one reason that companies might choose to pay termination benefits to an executive is to encourage them to leave the company due to poor performance. While this might appear from shareholders' perspective to be undesirable — additional money being paid to a poorly performing executive — the choice for boards in these circumstances is not simply between paying an executive or not. Rather, they could face a situation of paying an executive to go quietly, or potentially facing large legal costs if the executive challenges the termination. Offering the termination payment could be the least costly option for the company in these circumstances. By enabling the company to replace an ineffective executive quickly, shareholders would benefit.

Nonetheless, the case for shareholder involvement in decisions on termination payments is stronger than for other forms of remuneration. Termination payments will not generally exhibit a clear link to performance (unless an executive can somehow influence a company's performance after departing the company). While the absence of a link to performance is not of itself objectionable (base salary, for example, is a standard feature of remuneration, yet it is not strongly associated with performance), the opaqueness of termination payments — particularly those made on an *ex gratia* basis — could threaten shareholders' interests. Moreover, although shareholders' interests could be served from boards 'buying out' a poorly performing executive, they might also question how effectively boards are designing employment contracts when termination for 'failure' could result in the company being drawn into costly litigation (notwithstanding the common law rights of individuals, which companies cannot circumvent).

Of course, remuneration packages still need to be considered in their entirety. As some inquiry participants have noted, efforts to restrain one form of pay might be expected to provoke changes to other forms. To this end, the Australian Government's changes to termination payments could lead to a restructuring of packages (such as higher base pay or a sign-on bonus), or might result in the lowered threshold becoming a new 'floor' for termination payments (box 7.20).

The argument for setting a threshold for shareholder approval of termination payments is that some benefits will be of a sufficiently low level that requiring a vote would be trivial for shareholders and excessively costly. This raises the question, how much is too much?

Box 7.20 Consequences of reducing the cap on termination payments — views from submissions

Some inquiry participants noted the potential consequences from reducing the threshold for shareholder approval for termination payments. The Australian Bankers' Association stated it would 'have the effect of skewing remuneration packages towards greater reliance on base pay' (sub. 70, p. 3). Regnan noted:

> Past experience with the introduction of strict regulation around executive pay in the United States has illustrated the unintended consequence of restricting a single aspect of executive remuneration; other elements of remuneration are increased to compensate for/bypass the element of remuneration that has been restricted (the 'squeeze the balloon' effect). It is therefore our concern that other elements such as base salary or sign-on bonuses may experience artificial upward pressure in response to a strict shareholder approval threshold of 12 months' base salary for termination payments. (sub. 72, attachment, p. 1)

The Australian Human Resources Institute reported that respondents to its survey of human resource managers noted that of those companies likely to be affected by the reform to termination payments, most indicated:

> … it will be necessary to find some other way of spreading the present value of the forgone benefit into other remuneration elements either pre- or post-termination. Most companies have a present value income and also payment expectations when dealing with senior executives. Therefore if a regulation forbids them from operating within a certain part of the employee cost and payment curve, rational behaviour will drive them to find another delivery instrument. So the … termination cap is likely only to solve the political perception of high termination payments at the point of termination. (sub. 49, p. 9)

CGI Glass Lewis and Guerdon Associates observed that the threshold for shareholder approval should 'not be too low as to promote unintended consequences such as an increase in base pay, sign on fees or other types of discretionary bonuses' (sub. 80, p. 60). They suggested:

> … considering bringing the limit requiring shareholder approval more in line with international standards for attracting potential offshore executives. In addition, consider working with the ASX Governance Council to establish a principle for termination pay requiring a lesser maximum payment than the prescribed legal maximum on an 'if not, why not?' basis. (sub. 80, p. 101)

CGI Glass Lewis and Guerdon Associates also noted that implementing thresholds (such as that for tax penalties in the United States) can have the effect of increasing accepted practice to this threshold (sub. 80). David Peetz also acknowledged the risk that the new ceiling might become a 'floor':

> The danger is that the new ceiling on termination payments, of one year's salary before shareholders' approval must be sought, may also become a floor. Consideration should be given to a lower limit. The legal minimum for termination payments set out in the *Fair Work Act 2009* is a useful benchmark. It is unclear why CEOs, whose early termination is often brought about by poor performance in the job, should receive extraordinarily generous payouts on terms vastly superior to those available to ordinary employees dismissed for the similar reasons. (sub. 50, p. 13)

Clearly, the previous threshold of seven times total remuneration allowed large payments to go through which many shareholders considered egregious (a sample is contained in box 1.2, chapter 1). However, lower thresholds — such as the current one year's base salary — risk capturing payments that shareholders have few concerns about, imposing costs on companies (and ultimately shareholders) in terms of organising shareholder meetings. They might also motivate changes in the structure of remuneration packages.

The AICD (subs. 59 and DD149) expressed concern with the Government's reforms, and noted that they put Australian companies at a disadvantage in the market for executives compared to those in the United States, the United Kingdom and elsewhere in Europe (box 7.17). It suggested the threshold should be changed from one year's base pay to two times total remuneration. However, other participants supported the reduction to one year's average annual base salary (for example, Finance Sector Union, sub. 39; Stephen Mayne, sub. 63; ACSI, sub. 71).

Regnan proposed that shareholder approval be required for termination payments greater than *twice* base salary. For payments between one and two times base salary, the company would be required to provide a justification (along the lines of the 'if not, why not' disclosure regime established by the ASX Corporate Governance Council), but not offer a shareholder vote (sub. 72). This could reduce the potential for perverse consequences and provide flexibility for company boards. However, it is difficult to see how such a regime could work in practice. While boards have a strong incentive to explain their reasoning for a termination payment where a binding shareholder vote is in place — such a justification could make the difference between approval or rejection — it is unclear that such incentives could be replicated by a regulatory requirement. In particular, without a shareholder vote, how could the quality of a company's explanation be assessed? (Shareholders could vote against directors whose disclosure quality is poor, but this option already exists under the current regime where explanations are not required at all. As such, the threat of shareholders removing the board would appear to be a weak motivator on this particular issue.)

Given that the majority of contracted termination payments currently appear to be valued at between 10 and 15 months' fixed pay, the one year threshold would seem unlikely to cause difficulties in most circumstances. However, there would be benefit in reviewing the impact of the changes at some future point.

8 Remuneration disclosure

Key points

- Remuneration disclosure makes boards more accountable and provides information about company prospects, and can thereby reassure investors. But benefits must be weighed against compliance costs and potential commercial disadvantage.
- Disclosure requirements have evolved over many years. Currently companies each year must publish their remuneration policy and pay details for key management personnel and the five highest-paid group and company executives.
- The usefulness of remuneration reports is diminished by their length, detail and complexity, as well as by 'boiler-plating' and some crucial omissions.
  - Plain English presentation would promote investor understanding of executive pay. Company efforts to improve the readability of reports would be bolstered by guidance on best practice, including a remuneration 'checklist'.
  - Reporting the pay actually realised by executives would be useful to investors, as would fuller reporting of performance hurdles, taking account of commercial sensitivities.
- Minimising compliance costs for businesses can complement efforts to improve the quality of disclosure for shareholders.
  - There is scope to rationalise the coverage of executives named in the report, and to streamline the regulatory framework.
- There will always be some tension between report readability and length, and the desire of investors and advisers for comprehensiveness.

8.1 Current remuneration disclosure

Remuneration disclosure is one mechanism for constraining the scope for company *directors* benefiting from their position by awarding themselves excessive pay, and also for providing reassurance to shareholders that they are not doing so. And while *executives* technically do not set their own pay, disclosure of executive remuneration can make the board more accountable and reassure investors that the board is negotiating with executives at 'arm's length'.

Disclosure of remuneration packages also provides information to investors about the incentives being set for executives. This could assist them to assess the company's prospects and risk profile, such that the share price more accurately signals the market's assessment of the stream of expected profits. Thus, through improving investor confidence and providing relevant information about company prospects, disclosure could enhance efficiency in equity markets. As the OECD observes:

> A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis … Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. (2004, p. 49)

However, *unlimited* disclosure would be unlikely to deliver net benefits — for instance, detailed revelation of a company's strategy could undermine its competitive advantage and long-term performance. Again, according to the OECD:

> Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. (2004, pp. 49–50)

In other words, the benefits of transparency need to be balanced against compliance costs and possible adverse consequences for a company's commercial position. Furthermore, although not usually a stated objective, remuneration disclosure also brings additional information about executive pay arrangements in the market into play in negotiations between boards and senior executives, which is likely to have promoted the rapidity of pay adjustments, if not growth in pay itself (chapter 4).

Australia's disclosure requirements have been progressively strengthened

As discussed in chapter 2 (box 2.5), listed companies have been required to disclose information about executive pay for many years, but requirements have been progressively increased. For example, prior to 1998, listed companies were required to disclose pay in 'bands' for executives earning over $100 000, but executives did not have to be individually identified.

From July 1998, as part of the Corporate Law Economic Reform Program, disclosure requirements were amended to cover the actual remuneration packages of individual directors and the five highest-paid executives. These changes were consistent with pressure from various stakeholder groups, including the then

Australian Investment Managers Association (now the Investment and Financial Services Association), to bring disclosure requirements into line with the more detailed requirements of the United States and the UK's best practice disclosure methods (Clarkson et al. 2005). In July 2004, disclosure was extended to key management personnel, together with the introduction of the requirement for a separate remuneration report to be incorporated into the company's annual report. This report was to be subject to a non-binding shareholder vote.

Disclosure requirements and common practice

Under section 300A of the *Corporations Act 2001* (Cwlth), listed companies are required to publish annually in a section of the directors' report for the financial year:

- a discussion of the policy for determining remuneration
- a discussion of the relationship between the policy and company performance
- if an element of remuneration is dependent on a performance condition, a summary of the performance condition and explanation of why it was chosen
- remuneration details for key management personnel, including the five group executives and five company executives who earn the highest remuneration.

More detail on disclosure requirements contained in the Act and the accompanying regulations are set out in box 8.1. International requirements for disclosure are presented in box 8.2.

Box 8.1 **Current disclosure requirements**

The Corporations Act 2001

Remuneration details for key management personnel, including the five highest paid company executives and the five highest paid group executives include:

- where remuneration is based on equity, and is not dependent on a performance condition, an explanation of why, and board policy in relation to hedging unvested entitlements
- an explanation of the proportion of remuneration that is related to performance
- the value of options granted and exercised during the year
- the value of options that lapsed due to a performance condition not being met
- the percentage of remuneration that consists of options
- if employed under a contract, its duration, notice period and termination payments.

(Continued next page)

Box 8.1 (continued)

The Corporations Regulations 2001

The Corporations Regulations prescribe additional disclosure requirements, including:

- short-term benefits, divided into: salary and fees; short-term profit sharing and other bonuses; non-monetary benefits; and other short-term benefits
- post-employment benefits (superannuation and pensions)
- long-term benefits, separately identifying amounts due to a long-term incentive plan
- termination benefits
- share-based payments, divided into: shares; options and rights; cash-settled share-based payments; and any other share-based payments
- for each grant of a bonus, the terms and conditions of the bonus, including:
  - the grant date and the nature of the remuneration
  - the performance criteria used
  - details of any alteration in the terms of the grant
  - the percentage of the bonus paid and percentage forfeited in the financial year
  - estimates of the maximum and minimum possible value of the grant
- if the terms of a share-based payment grant have been altered:
  - the terms of the grant immediately before alteration and the new terms
  - the difference between the value of the grant before and after the alteration
- for each grant of options or rights:
  - the number that have been granted and vested during the period
  - their terms and conditions, including fair value, and exercise price and date.

In meeting these detailed remuneration report requirements, companies typically:

- include an upfront, broad statement on remuneration policy (examples are contained in box 8.3). This is often supplemented with additional statements on specific remuneration types — for example base salary, short-term incentives and long-term incentives
- do not normally separately discuss the link between the remuneration policy and company performance. Instead, the remuneration policy will sometimes include reference to company performance, while discussion of short- and long-term incentives illustrates how remuneration is related to company performance. In addition, remuneration reports often include performance information (total shareholder returns), sometimes compared to long-term incentive arrangements

Box 8.2 **Remuneration disclosure — international approaches**

Germany — public limited companies must provide a breakdown of total earnings of each member of the management board. Companies can opt out where three quarters of shareholders vote to do so and only for a maximum of five consecutive years (Federal Ministry of Justice Germany 2009).

France — in 2008, French peak business bodies Medef and AFEP (2008) jointly released a standardised tabular format for executive remuneration disclosure which details:

- remuneration for each executive director for the current and previous year, both in terms of amount due and amount already paid
- shares and options awarded or exercised that year.

In March, the representative body of the French investment management industry recommended that remuneration disclosure should be provided as a three-year summary of remuneration packages for each director to enable shareholders to track changes more easily.

United Kingdom — the *Companies Act 2006* requires detailed disclosure on remuneration policy and a breakdown of total earnings for each director. In addition, explanations must be provided for any performance conditions and methods used to assess the fulfilment of these conditions. Where performance conditions are not attached to long-term incentive plans an explanation must be provided. A summary explanation of company policy on the duration of contracts with directors, and notice periods and termination payments under such contracts, is also required.

United States — executive and director remuneration disclosure has been required for some time in the United States, with the Securities and Exchange Commission releasing strengthened requirements in October 2006 (SEC 2006). These amendments provide investors with a clearer and more complete picture of remuneration to principal executive officers, principal financial officers, the other highest paid executive officers and directors through both tabular and narrative reporting.

- discuss and present detailed information on short- and long-term incentive remuneration. Given issues of commercial sensitivity, the level of disclosure and discussion around long-term incentives is greater than that for short-term incentives (chapter 7)
- provide detailed information on relevant individuals' remuneration (usually in tables). As they cover all forms of remuneration (for example: fixed, non-monetary benefits; short- and long-term incentives (including share and option schemes); post-employment benefits; and termination pay), these data and supporting commentary generally comprise the bulk of remuneration reports.

Box 8.3 **Some remuneration policy statements**

BHP Billiton's 2009 remuneration report comprises 11 pages of its annual report and includes principles to:

- provide competitive rewards to attract, motivate and retain highly-skilled executives willing to work around the world
- apply demanding key performance indicators, including financial and non-financial measures of performance
- link a large component of pay to our performance and the creation of value for our shareholders
- ensure remuneration arrangements are equitable and facilitate the deployment of people around our businesses
- limit severance payments on termination to pre-established contractual arrangements that do not commit us to making unjustified payments. (BHP Billiton 2009, p. 148)

AMP's 2008 20-page remuneration report includes the following statement:

> The AMP Board's approach to executive remuneration is to align remuneration with the creation of value for AMP shareholders. AMP's remuneration is market competitive and aims to attract, retain and motivate high calibre employees who contribute to the success of AMP's business. AMP pays for performance. All executives have a significant component of their remuneration at risk. (AMP 2008, p. 12)

The Commonwealth Bank's 2009 20-page remuneration report includes guiding principles to:

- motivate employees to work as a team to produce superior sustainable performance achieving the Group's vision
- be transparent and simple to understand, administer and communicate
- be market-competitive. (Commonwealth Bank 2009, p. 67)

Although remuneration reporting appears to have worked reasonably well thus far, both shareholders and companies (as well as proxy advisers, corporate governance experts and remuneration consultants) have indicated that there is scope for improvement. The concerns over current remuneration practices give rise to two related, but separable, questions:

- What do shareholders want to see in remuneration reports? (section 8.2)
- How can disclosure requirements best meet the needs of shareholders, while minimising compliance costs to businesses? (section 8.3)

8.2 Are remuneration reports clearly communicating what investors want to know?

As the requirement to provide a remuneration report is comparatively recent, companies continue to learn and to adapt their reports to best meet the requirements of shareholders. There has been no guidance for companies about how best to communicate the required information (for example, via a template or best practice guide) and thus companies individually have determined how to meet the requirements of the Act and communicate the required information.

A major area of concern is the length and complexity of reports, with many investors stating they find them impenetrable (box 8.4). Reports are routinely 20 pages in length, and some are over 50 pages. Both their length and complexity reflect the breadth and complexity of remuneration arrangements. They also reflect what companies consider they must do to comply with the not insignificant statutory requirements. A number of participants described the approach commonly taken by companies as legalistic 'boiler-plating' — that is, they attempt to shield themselves by using standard terms to describe arrangements. Such terminology is not particularly illuminating for investors.

Box 8.4 **Participants' views on the length and complexity of remuneration reports**

Many participants expressed views on the length and complexity of remuneration reports. Comments included:

> It is not unusual for the statutory remuneration reports of large listed companies to run to 20 pages or more of detailed disclosures which can be largely impenetrable to the lay reader. (Chartered Secretaries Australia, sub. 57, p. 18)
>
> Remuneration reports have become lengthy and very detailed. Transparency and accountability could be increased if … requirements were simplified. (Macquarie Group, sub. 52, section 2, p. 6)
>
> … the desire for greater transparency has actually led to the reverse in that remuneration reports are now so complex that they are very difficult for a typical shareholder to understand. Transparency and accountability could be increased if the remuneration report requirements were simplified … (Australian Bankers' Association, sub. 70, p. 15)
>
> Woolworths' latest remuneration report is 19 pages long and includes 9 pages of remuneration tables. We believe, the important information that a shareholder wants to understand often gets lost in the detailed requirements. (Woolworths, sub. 91, p. 9)
>
> Complex reporting requirements reduce the impact of the information being disclosed and make it more difficult for shareholders to extract meaningful information from remuneration reports. (Freehills, sub. 46, p. 7)
>
> [Remuneration disclosure] has been corrupted by linking it to accounting and other standards so that what has to be disclosed is both highly complex and, hence, difficult for even sophisticated investors to grasp and, especially in the case of equity-based long-term incentives, totally fails to provide an accurate and meaningful disclosure of what the executive has actually received for the year under report. (Allens Arthur Robinson et al., sub. DD170, p. 4)

In addition to complaints that remuneration reports are neither succinct nor 'user friendly', there is widespread concern that some requirements are not being fully complied with, and that some relevant information is omitted from the disclosure regime. Specific criticisms include that:

- discussion of remuneration policy and the links between remuneration and performance is cursory at best
- pay as *actually realised* by executives is not required to be reported
- current *ex ante* valuations of equity-based pay are inadequate
- short-term performance hurdles are rarely adequately disclosed.

These concerns are discussed below, with options to address current weaknesses in disclosure requirements canvassed in chapter 11.

What would the 'ideal' remuneration report look like?

The adequacy of remuneration disclosure can be assessed against two benchmarks: transparency and simplicity. In many respects these two factors support each other. For example, a simple, 'user friendly' remuneration report can give shareholders a strong understanding of what a company is doing. However, the goals of transparency and simplicity can also come into conflict, particularly where complex arrangements are discussed — maximum 'transparency' (disclosing everything possible) may only confuse shareholders, while an emphasis on 'simplicity' could leave shareholders with too little access to detail. Hence, it is important to consider not just what remuneration reports should contain, but also how the content should be presented.

'Best practice' examples?

The Commission understands that a number of companies are making efforts to improve the readability and presentation of material in their remuneration reports. As an illustration, Caltex's 2007-08 report was cited by some institutional investors as approaching 'best practice'. The report's use of summary flowcharts helps to promote a clearer understanding of the links between company performance and remuneration outcomes, as well as the links between an individual's total incentive payment, individual performance and department performance, and Caltex's overall performance. The report explains that Caltex's overall performance determines incentive payments such that if the overall performance threshold is not met, no department performance payments are made. (However, a limited budget is available for the individual performance incentive.)

For the 2008-09 reporting season, some investors praised Boral's remuneration report. This may be at least partly attributable to the majority 'no' vote the company received on its remuneration report the previous year, which prompted the board to review its practices. Boral's remuneration report includes a two-page summary, outlining the results of its remuneration review and disclosing pay levels realised by senior executives (as opposed to only the accounting values). The report also discussed changes to the CEO's remuneration structure and relevant contract terms.

Nevertheless, trying to determine what is 'best practice' in designing remuneration reports is challenging. Different readers will seek different information from remuneration reports. In this regard, the style of disclosure will not only tend to vary with the company's own circumstances (for instance, the complexity of pay arrangements), but also with the composition of shareholders in any given company. Consequently, developing a 'template' for remuneration reports is unlikely to be appropriate. That said, there is a need to ensure consistent disclosure of information relevant to shareholders.

Key features for remuneration reports

Ernst and Young (sub. DD136) submitted that remuneration reports ideally should contain discussions on remuneration strategy, the use of short- and long-term incentives, the nature of contractual arrangements, and the link between pay and performance. Additionally, the report should provide data on remuneration outcomes, including 'actual' pay levels (that is, the amount realised by executives, rather than the accounting-based estimates currently disclosed). Ernst and Young also suggested that remuneration reports contain a descriptive, 'at a glance' summary, to identify the main features of the remuneration framework and highlight key changes made to remuneration practices and policies. (The details of this proposal are contained in the annexe to this chapter.)

In two joint submissions, Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (subs. DD168 and DD170) suggested that important factors to be discussed in remuneration reports included the link between pay and performance, how remuneration was benchmarked against comparator groups, whether the different parameters of incentive schemes had been adequately tested to account for 'extreme' outcomes, and the role of remuneration committees. Included in the submissions were tables proposing how 'realisable' pay (the value of payments at vesting), fair values (the estimated value of payments at grant date) and total executive shareholdings in the company could be reported. (Further details are contained in the annexe to this chapter.)

Proposals such as these identify that shareholders are not simply interested in the amounts paid to directors and executives (the 'what'), but also the framework under which such payments are made and the justification for the amounts being offered (the 'how' and 'why'). These qualitative factors are harder to prescribe, but are nevertheless critical to the clear communication of remuneration policies and practices to shareholders. Aspects worthy of discussion include:

- how remuneration is structured to align with the company's (and ultimately shareholders') interests, taking account of the company's growth plans, strategy and risk profile
- what roles fixed pay, and short- and long-term incentives play in the company's remuneration policy
- whether the company has sought to benchmark remuneration levels and structure against relevant peers
- to what extent sensitivity analysis has been undertaken to project potential remuneration outcomes, particularly in the light of extreme share price movements and in performance against selected metrics
- given the possibility of extreme share price movements or other unexpected performance outcomes, to what degree formula-based contractual obligations can be modified to guard against 'excessive' pay
- why specific remuneration instruments have been selected, and whether simpler alternatives were considered
- what contractual provisions apply in the case of termination, particularly with regard to poor performance
- how remuneration policies and practices are evaluated over time, taking account of pay outcomes, the relationship between pay and performance, and the results of sensitivity analysis.

Improved disclosure in these areas would give shareholders a more complete understanding of companies' approaches to remuneration. In many respects, they also mirror guidance on remuneration by the Australian Prudential Regulation Authority (APRA) for financial institutions (box 8.5). That said — and as some participants noted (Hay Group, sub. DD132; PricewaterhouseCoopers, sub. DD138) — greater discussion will add to, rather than subtract from, the length of remuneration reports. This effect may be mitigated by changes in other areas.

Box 8.5 APRA's requirements for remuneration policies in the financial sector

From April 2010, financial institutions regulated by APRA will be required to have a formal remuneration policy. While the contents of such a policy will vary between institutions (in particular, APRA acknowledges that larger, publicly-listed institutions will likely have more complex policies), factors that are expected to be discussed include:

- how remuneration is adjusted for risk
- how performance is measured (and how these outcomes are reviewed over time)
- the mix of fixed and incentive-based pay
- how 'extreme outcomes' are addressed — particularly where the financial soundness of the institution is threatened, but also in other circumstances (such as unexpected losses or reputational damage)
- the link between pay and performance, with specific regard to:
  - equity-based payments (and deferral of rewards)
  - executive lending and leveraging arrangements
  - sign-on bonuses and termination payments
  - hedging policies
  - perquisites.

Source: APRA (2009c).

Disclosure of remuneration policy and the link to performance

Various proposals have been made to reduce the length and complexity of remuneration reports, as well as to enhance their readability, including:

- streamlining existing reporting requirements (section 8.3)
- requiring a short-form report, additional to the existing report
- a plain English approach to describing remuneration policy and arrangements.

While a short-form report could enhance accessibility for investors, it would also impose an additional burden on companies. Production of the remuneration report already involves significant time and effort for companies and their boards (box 8.6). Moreover, in practice, if a short-form report simply replicated a subset of complex material from the full report or, at the other extreme, gave an overly simplistic and potentially misleading view of complex remuneration structures, it would not add value.

Box 8.6 **The compliance burden**

On the issues of cost and time to produce a remuneration report, Freehills made the following comments:

> The cost to the company associated with producing a remuneration report is substantial. These costs arise from the significant time and effort required from management to draft the remuneration report, the engagement of external consultants to assist with this specialised task, as well as the cost of obtaining appropriate legal and audit compliance checks.
>
> Simplifying the disclosure requirements … could reduce these compliance costs, and will have the corresponding advantage of encouraging companies to approach the remuneration report as a meaningful communication tool (as was intended by the legislature), rather than a 'compliance exercise'. (sub. 46, p. 7)

Charles Macek also commented on the time spent by non-executive directors on compliance issues such as the remuneration report, stating that 'directors are spending increasing amounts of their time on compliance to the detriment of oversight of strategic and business risk issues' (sub. 55, p. 13). He also noted that the workload of the remuneration committee chair is approaching and sometimes exceeding that of the audit committee chair, with 'the latter committee [having] oversight of all of the company's risks while the former is merely dealing with one set of contracts' (sub. 55, p. 13).

Enhanced accessibility might be better achieved, at lower cost, by clearer presentation of material, including the provision of a succinct overview or summary of remuneration policy and arrangements at the beginning of the report.

A summary of remuneration policy and arrangements?

A company's remuneration policy provides information on how remuneration of key management personnel is determined and the philosophy behind that approach. In addition, it can provide an indication of the company's broader approach to performance and strategy.

Section 300A of the Corporations Act does not prescribe what should be covered in the policy, simply stating the remuneration report should include discussion of board policy for determining the nature and amount of remuneration of key management personnel. Because of the wide range of companies to which the Act applies, non-prescription arguably is appropriate (box 8.3 includes examples of remuneration policies).

But given the length and complexity of remuneration reports, a summary presentation of company remuneration policy and arrangements could be helpful to investors.

As noted by the Australian Council of Super Investors (ACSI):

> ACSI recognises that … it is very challenging for a company to provide in 'plain English' a snapshot of its philosophy on remuneration and the implications this has on key management personnel … In particular, ACSI would support the listing rules and relevant legislation to encourage a brief summary of a company's approach in plain English … [on] the company's philosophy on remuneration, in particular the synergies with strategy and performance objectives … (sub. 71, p. 11)

Similarly, the Australian Bankers' Association stated:

> Transparency and accountability could be increased if the remuneration report requirements were simplified and focused on information that shareholders are really interested in, namely:
>
> - What is the company's remuneration policy and is there an appropriate level of remuneration governance? (sub. 70, p. 15)

Other submissions, including from ACSI (sub. DD156), Charles Macek (sub. 55), Chartered Secretaries Australia (sub. 57), CGI Glass Lewis and Guerdon Associates (sub. 80), Hay Group (sub. 84), Kym Sheehan (sub. DD137), PricewaterhouseCoopers (subs. 85 and DD138) and Ernst and Young (subs. 92 and DD136), also identified scope to improve clarity in the discussion of remuneration policy and arrangements.

Nonetheless, some inquiry participants expressed reservations about a plain English summary (for example, Australian Shareholders' Association, sub. DD121; Australian Securities Exchange (ASX), sub. DD142). KPMG observed:

> The inclusion of a plain-English summary of remuneration policies is unlikely to address the issues of complexity and ability to be readily understood by investors. Rather, it is likely to increase the overall length of the remuneration report, add to compliance costs and lead to unnecessary further debate where investors seek to reconcile points of detail in the statutory report with the general comments in the plain-English section. In addition, what is considered plain-English is subjective and likely to differ between readers. (sub. DD145, p. 2)

Other participants suggested that a summary be 'non-statutory' in nature (for example, Chartered Secretaries Australia, subs. 57 and DD147; National Australia Bank, sub. DD153). This suggestion arose from concerns that a summary of companies' remuneration policies, if it were prescribed by the Corporations Act, would be subject to the same legal requirements as the rest of the remuneration report. As such, its comprehensibility as a 'plain English' document would likely be compromised by legalistic language. Still, 'plain English' explanations have been mandated in other areas with some success (box 8.7), including in the United States with respect to remuneration disclosure (box 8.8).

Box 8.7 **Experiences with plain language**

Some participants expressed concern about mandating 'plain English' reporting. For example, The Business Council of Australia argued:

> Companies will most likely have to obtain legal advice to ensure that they have drafted a 'plain English' summary. It is difficult to see how the concept of 'plain English' can be appropriately defined in the law or how companies will comply with the requirement from a legal perspective. (sub. DD152, p. 13)

However, there are several examples from around the world where plain language has been legislated for.

- In the **United States**, warranties have had to be produced in 'simple and readily understood language' since 1975. Some states have enacted laws mandating plain language be used in residential leases and consumer contracts. Another example is a requirement by the SEC for prospectuses to be 'clear, concise and understandable' and be drafted using 'plain English principles' (box 8.8). To assist in this process, the SEC has produced a 'plain English' handbook for US companies.
- Since 2000, **Canada** has required mutual prospectuses to be drafted in plain language. Additionally, many provinces require contracts to be drafted in 'plain', 'comprehensible' or 'intelligible' language.
- The **European Union** has enacted requirements for standard terms in consumer contracts to be expressed in 'plain, intelligible language'. Failure to comply can result in a contract term being ruled unfair.

Source: Asprey (2004).

Requiring plain English explanations might provide a useful signal even if it were impractical to enforce fully in practice. To help companies improve their reports, there could be merit in representative (including investor) bodies developing a best practice guide. (As noted in box 8.7, the Securities and Exchange Commission (SEC) produces a plain English handbook for companies in the United States.) In addition, or as an alternative, company reports that clearly convey information to investors could be identified and publicised as best practice.

Disclosure of 'actual' pay

Remuneration reports currently emphasise payments granted to an executive in a given financial period. Typically in the case of cash payments — base salary or annual cash bonuses — the executive realises the full benefit at granting. However, this is often not the case for equity-based remuneration, where an award granted today might not be paid out for years (consistent with promoting long-term performance). Rather than disclosing the value of equity the executive ultimately receives, remuneration reports reveal only accounting costs — essentially the contingent liability for the company.

Box 8.8 **'Plain English' principles**

In 2006, the SEC announced amendments to the US remuneration disclosure regime. As part of the changes, the SEC required companies to adhere to 'plain English' principles in reporting director and executive remuneration. The SEC noted that companies should:

- present information in clear, concise sections, paragraphs and sentences
- use short sentences
- use definite, concrete, everyday words
- use the active voice
- avoid multiple negatives
- use descriptive headings and subheadings
- use a tabular presentation or bullet lists for complex material, wherever possible
- avoid legal jargon and highly technical business and other terminology
- avoid frequent reliance on glossaries or defined terms as the primary means of explaining information
- define terms in the glossary or other section of the document only if the meaning is unclear from the context
- use a glossary only if it facilitates understanding of the disclosure
- in designing the presentation of the information, include pictures, logos, charts, graphs, schedules, tables or other design elements so long as the design is not misleading and the required information is clear, understandable, consistent with applicable disclosure requirements and any other included information, drawn to scale and not misleading. (SEC 2006, p. 53 209)

Consistent with these, the SEC also advised companies to avoid:

- legalistic or overly complex presentations that make the substance of the disclosure difficult to understand
- vague 'boiler plate' explanations that are overly generic
- complex information copied directly from legal documents without any clear and concise explanation of the provision(s)
- disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information. (SEC 2006, p. 53 209)

As discussed in chapter 7 and appendix E, under accounting standards, the cost to the company of equity-based payments must be calculated at the *grant* date, taking into account an estimate of when the option or right will be exercised and the probability that any vesting conditions will be met (such as performance hurdles). These estimates will also be discounted for effects of time where actual payments will occur some years in the future.

Many participants expressed concern that reported equity-based pay did not represent 'actual' remuneration and, moreover, that this was not well understood by shareholders and the broader community (box 8.9). Reporting long-term incentive remuneration inevitably involves a tradeoff between ensuring reasonable time proximity and reflecting what an executive has 'actually' received. Current reporting of accounting values provides close proximity (since values for incentive payments are reported in the year that they are granted) but limited indication of what the executive will eventually take home. By contrast, 'actual' pay might not become apparent for some years after the grant date, but will give a clear indication of the gains actually received by the executive. In this regard, reporting 'actual' pay would assist shareholders in understanding companies' remuneration practices, and provide greater clarity on the link between pay and performance.

Box 8.9 **Reported *vs* actual remuneration — views from submissions**

The Joint Accounting Bodies noted the difference between actual remuneration and the cost to the company (reported remuneration):

> It is important to note that [share-based payments] are valued at fair value at the grant date and then expensed (and disclosed) by the company over the vesting period. However, … the value of the [share-based payment] to the [key management personnel] at the vesting date is unlikely to reflect the amounts recognised through the profit or loss over the vesting period. We do not consider that this is an area fully understood by users … (sub. 77, p. 3)

CGI Glass Lewis and Guerdon Associates similarly stated:

> The value of equity based incentives is required to be amortised over the performance period, which may be up to five years … The resulting figure will have no correlation to the executive's level of remuneration in the year under report. (sub. 80, p. 70)

Freehills commented:

> … the numerous disclosure requirements in respect of equity grants are both time consuming and difficult for retail shareholders to understand … the disclosures in the remuneration report should be structured on the basis of the *actual* value derived by the executives … (sub. 46, p. 7)

Mercer stated that it was:

> … concerned that current disclosure requirements are not representative of the actual remuneration received by executives … (sub. 41, p. 9)

RiskMetrics noted that equity values reported are often far below realised value:

> RiskMetrics has observed that prior to August 2006, the fair value of equity incentives granted to CEOs of large companies was routinely far below the actual realised value. (sub. 58, p. 11)

It should be noted that there is no impediment to companies voluntarily disclosing actual equity remuneration. (Indeed, some have done so — for example, Boral and National Australia Bank in 2009.) It has been conjectured that the realised gains to executives have not been disclosed because in the boom years preceding the global financial crisis, accounting values may have been systematically lower than actual equity payments. However, as discussed in chapter 4, in the absence of full information there is no way of verifying this — there are examples of some executives receiving more than accounting values, some less. Moreover, realised amounts expressed in today's dollars always will be more than estimates at grant date simply because the latter are expressed in dollars from an earlier period.

What is 'actual' pay?

Determining what has been 'actually received' is not a straightforward exercise, given the complexities associated with equity-based pay instruments. Ernst and Young (sub. DD136) noted that inconsistent approaches in disclosure currently exist among companies that have voluntarily reported 'actual' pay levels. As with other aspects of remuneration disclosure, it is important that 'actual' pay be reported in a consistent manner.

'Actual' pay should, in principle, reflect the point at which an employee receives a benefit over which they can exercise control. This does not necessarily mean when a *cash* gain has been realised — for example, the point at which shares are sold. As Hay Group argued, 'the actual realised value at the point of selling the shares is not relevant for remuneration purposes, as the sale may be deferred for many years' (sub. DD132, p. 7). Moreover, any change between the share price at vesting and upon sale reflects a capital gain or loss for the executive rather than the employment-related income. (Indeed, such gains or losses would be taxable at the capital gains tax rate rather than under the income tax system.) At the other extreme, valuing equity-based payments at grant date is not consistent with 'actual' pay either. In the case of long-term incentives, there remains a risk that the executive will not actually receive a benefit (for example, due to a failure in meeting vesting conditions).

Many inquiry participants identified the vesting point as being appropriate for defining 'actual' pay (ASX, sub. DD142; Hay Group, sub. DD132; Macquarie Group, sub. DD157; Regnan, sub. DD159). At vesting, the executive takes receipt of shares from the company, which he or she is able to sell (although the shares may still be subject to holding locks, which restrict the holder from disposing of them). At the point where shares have been transferred from the company to the executive, the shares can be valued at the market-traded price.

Guerdon Associates suggested that actual remuneration be 'defined as the value of all remuneration that vests to the employee in the fiscal period. This would include cash, contributions to superannuation, fringe benefits, the market value of shares, and the realisable value of options' (sub. DD119, p. 5).

What is the 'actual' value of an option?

A separate concern arises with options, as vesting does not confer shares on the executive, but instead the right to acquire shares at an agreed price by a specified future time. It is when this right is exercised that a cost to the company is incurred, and the executive receives a pecuniary benefit (the difference between the market share price and the agreed 'exercise' price that the executive pays). This 'intrinsic value', reflects what the company has contributed to the executive's acquisition of equity. PricewaterhouseCoopers (sub. DD138) suggested that the exercise point would be suitable for reporting 'actual' pay in the case of options.

Exercise complicates the assessment of remuneration, as this amount is partly dependent on when the executive makes a choice (that is, when he or she chooses to exercise the options). If an executive chose never to exercise an 'in the money' option (one where the share price exceeds the exercise price), he would be voluntarily forgoing part of his pay. In this case, it would seem unreasonable to disclose as 'actual' pay what the executive never received (and a cost that the company never incurred). A similar principle would apply if an executive held an option that was previously 'in the money', but which had fallen 'out of the money' (that is, the share price fell below the exercise price, rendering the option intrinsically worthless) before the option expired. In this case, had the executive exercised the option earlier (when it was 'in the money') and immediately sold the shares, he would have received a benefit. That the executive had not exercised early to claim that benefit is a function of his own judgment about timing — an issue that is more closely related to capital gains and losses than employment-related income.

In contrast, Guerdon Associates (sub. DD119) and Regnan (sub. DD159) argued that options should only be calculated at their intrinsic value at the vesting date. This 'realisable' pay reflects the benefit executives would receive if they exercised their options at the first possible opportunity. This approach would strip away the effect of gains and losses stemming from executives' own decisions on when they exercised their options. However, reporting realisable pay would also mean that an option that was 'out of the money' at vesting would be disclosed as providing no 'actual' pay to the executive (since the intrinsic value would be zero), even if the option later turned 'in the money' and was consequently exercised — with the company incurring a remuneration-related cost that would not be revealed in the remuneration report.

An alternative to the intrinsic value approach to realisable pay is to recalculate the option's fair value at vesting. As such, an option that was 'out of the money' at vesting could still be reported as having a positive value, reflecting the potential for that option to be 'in the money' before expiration. (This approach is broadly consistent with the assessment of options for income tax purposes, although there are separate issues about option valuation in this context — see chapter 10.) An obvious drawback is that — as with grant date fair values — the actual value eventually realised by the executive might bear little resemblance to the estimate. (That said, a fair value calculated at vesting will tend to be more accurate than one calculated at grant date, since the additional time provides further information about the share price path, which in turn narrows the range of expected possible outcomes at exercise or expiry.)

In short, neither the exercise nor vesting points are ideal measures for the 'actual' value of options. Valuing at exercise will provide the best information on the cost to the company, while adopting realisable pay at vesting will give a clearer indication of the executive's remuneration income (removing the effect of capital gains or losses). However, as discussed below, valuation at vesting may have compliance cost advantages, because this is the basis for income tax assessments.

Disclosure of fair value estimates

Current valuation of long-term incentive payments relies on estimates calculated at grant date — a value that will likely differ from the true cost the company will face at exercise (if the instrument is exercised at all). As a pecuniary cost has not yet actually been incurred (rather, it is an expected future cost), valuation techniques must be used to provide an appropriate value for the company's accounts (see appendix E). This is the principle of 'fair value' accounting.

Guerdon Associates commented that 'fair value' is not currently disclosed in remuneration reports. Instead, it is used as an input to an 'accounting value'. It explained the distinction between these two terms:

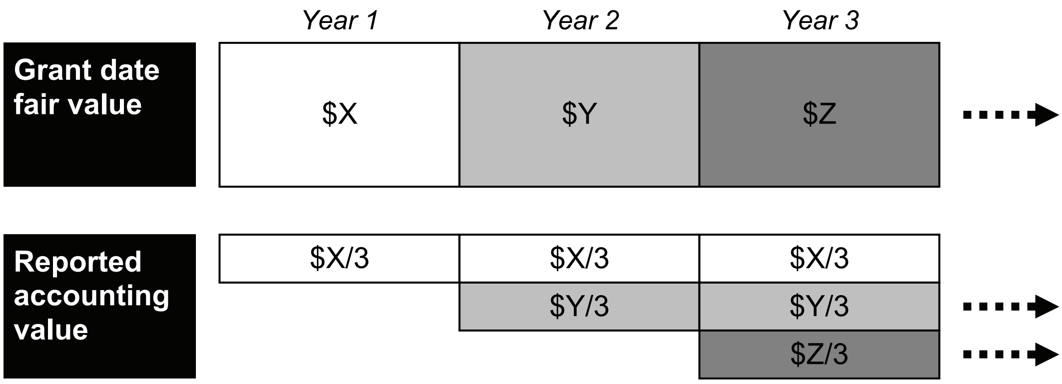
> Fair value is an arm's length objective assessment of the potential market price of a compensation item in the year of grant. Accounting value includes the fair value of compensation, but amortises it over the period of service to which that item of compensation pertains. (sub. DD119, p. 6)

Box 8.10 provides an illustrative example of this difference.

Guerdon Associates (sub. DD119) and Regnan (sub. DD159) both suggested that fair value be covered in remuneration reports rather than the accounting value(which would instead be contained in the financial statements). They argued that this would give a clearer indication to investors of how much executives are granted in any given year. In the context of the earlier example, the executive's long-term incentive remuneration in year three would not be reported as including amortised amounts from his first and second years at the company, but instead the (non-amortised) entirety of the amount as valued in his third year.

Box 8.10 **Fair value versus accounting value — an illustrative example**

The following example illustrates the difference between fair value and accounting value for an equity-based instrument that vests over three years:



In year 3, the fair value of equity to be awarded to an executive is $Z. However, the reported accounting value includes only a portion of that amount, combined with portions of grants from the previous two periods.

Disclosure of grant date fair value (rather than accounting values) was adopted by Canada in 2009, and the United States is also considering this approach (Lang Michener 2009; Willkie Farr and Gallagher 2009, p. 1). In Canadian practice, and in US proposals, accounting values are retained for the financial statements. There may be merit in considering this approach for Australian disclosure requirements as well, although the benefits should be weighed against the costs for companies (producing up to three sets of numbers — the accounting value for the financial statements, the grant date fair value, and 'actual' pay — to describe the same payment), as well as for shareholders (changing how accounting-based estimates of pay are reported may provoke further confusion, at least in the short term).

‘Actual’ pay, accounting-based estimates, or both?

Some participants felt that only ‘actual’ remuneration (however defined) is of interest to shareholders, while others considered that both estimated and actual outcomes were relevant. Retail investors and the general community are likely to be more interested in actual remuneration received by the executive. Others, such as proxy advisers, governance groups and institutional investors, are likely also to be interested in the accounting valuation of equity, to gain a more complete understanding of a company’s remuneration policies, the incentives being provided to executives, and their potential financial impact on the company.

A compromise suggestion made by the Joint Accounting Bodies (comprising CPA Australia, the Institute of Chartered Accountants and the National Institute of Accountants) was to include actual remuneration in the remuneration report, while reporting the accounting values and methodologies only in the financial statements (where they are also currently reported):

> These [accounting] estimates on day one are based on models and different proven valuation methodologies. So to be showing people what’s going through the accounting records, and they often are the numbers that get picked up by the media and strewn through papers, it’s not necessarily reflecting the true position. We think that to cut the confusion there is scope to look more at the type of information the shareholders really want and put it in a context that is reflecting the value to the executive at the date where the executive is able to do something with those options or to do something with those shares. (trans., p. 258)

While this suggestion has some appeal, the financial statements do not break down the estimates by individual executive. This would tend to limit the usefulness of the disclosure, particularly where the remuneration mix and the performance hurdles vary by executive.

An alternative would be to present in the financial statements the detail of the equity valuation methodology (thereby removing some technical detail from the remuneration report), while presenting estimates and actual remuneration by individual executive in the remuneration report. This approach may help to ensure that disclosure is comprehensible, without making it less comprehensive. In particular, technical material is likely to contribute to the confusion of ordinary shareholders, but may still be highly useful for proxy advisers and other remuneration specialists. Ensuring such details are still disclosed, but separating them from the remuneration report specifically, can help balance the needs of different readers.

'Actual' pay is not a perfect measure

Disclosure of actual payments to executives could promote more accurate reporting of executive remuneration, particularly as it would distinguish remuneration from capital gains (or losses). However, misunderstandings about discounting for time, the difference between real and nominal amounts, as well as reasons for differences between an estimate based on probabilities of the executive's performance level and share prices, and the realised outcome, would likely persist.

Some participants expressed reservations about requiring 'actual' pay to be reported. For example, although Hay Group supported calculation of actual levels of remuneration at vesting, it also observed that this 'actual' pay value would:

> … be objective but [have] limitations for remuneration purposes. The value cannot be shown until well after the [long-term incentive] has been granted and approved, if necessary, by shareholders. This will then involve the Board justifying the outcome of decisions made in good faith three years ago. Potentially those decisions were made in different circumstances by a differently constituted Board. They will now be judged by commentators enjoying the benefits of hindsight. (sub. DD132, p. 7)

Specifying a precise definition of 'actual' pay may have limited benefits, while adding new disclosure requirements will add to businesses' compliance costs. CPA Australia (sub. DD148) and the Institute of Chartered Accountants (sub. DD146) observed that companies already had to calculate an 'actual' amount of pay for income tax purposes, and suggested that this could be reported with little additional compliance cost to businesses. This approach would define remuneration at the point when an individual is assessed to have received payment for income tax purposes and would, in principle, be consistent with reflecting an executive's realisation of benefits. That said, problems could emerge in the case of options, with the effect of performance hurdles excluded from the valuation of options for tax purposes (chapter 10). However, the Board of Taxation is currently conducting a review of the option valuation rules, an outcome of which may be to resolve this issue. Were this matter to be adequately addressed, remuneration as assessed for income tax purposes could be a workable definition of 'actual' pay.

Disclosure of performance hurdles

As incentive payments are forming an increasing proportion of executive remuneration packages, disclosure of performance conditions is important for investors to determine the appropriateness and risks of remuneration structures. Yet as shown in chapter 7 (tables 7.4–7.7), in 2007-08, only one of the top 20 companies disclosed the actual performance hurdle for payment of (some) short-term incentives. In contrast, a majority provided specific information about long-term incentive hurdles.

Section 300A(1)(ba) of the Corporations Act states:

> If an element of the remuneration of a member of the key management personnel … is dependent on the satisfaction of a performance condition:
>
> (i) a detailed summary of the performance condition; and
>
> (ii) an explanation of why the performance condition was chosen; and
>
> (iii) a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen …

As outlined in box 8.11, a number of participants considered companies were not complying with these requirements, and that the regulator, the Australian Securities and Investments Commission, was not taking remedial action. Nonetheless, the Corporations Act requires a '*detailed summary* of the performance condition' to be disclosed, not the actual condition. Thus, in providing information about the nature of performance hurdles, but not the levels of performance required to obtain the incentive payment, companies may be complying with the letter of the law. However, Guerdon Associates countered that:

> Regulation 2M.3.03 [of the Corporations Regulations] is very specific, and requires disclosure of sufficient detail to provide an understanding of 'how the amount of compensation in the current reporting period was determined'. Judging from the submissions made to the Commission to date, current disclosure practice has clearly not met this objective. (sub. DD119, p. 5)

Requiring companies to disclose full details of all performance hurdles would likely reveal commercially-sensitive information to competitors. In particular, short-term hurdles typically involve both financial and non-financial metrics that are more likely to be company specific, compared with long-term hurdles related to publicly-available indicators of company performance against general market indicators. Even where a performance hurdle has been met and incentive payments made, disclosure of the performance hurdle may, on some occasions, still not be in the company's best interests. For example, a bonus related to a performance hurdle to improve occupational health and safety outcomes, such as the number of fatalities, while worthy, could appear simply mercenary.

Freehills commented:

> … increased disclosure of short-term performance measures should be resisted, as disclosure of this information may impair companies' ability to keep commercial information in confidence. Companies may still voluntarily disclose such measures in retrospect, if appropriate … (sub. 46, p. 7)

Box 8.11 **Compliance with disclosure of performance conditions — views from submissions**

In regard to meeting disclosure requirements on performance conditions, CGI Glass Lewis and Guerdon Associates stated:

> … fewer than 20 per cent of listed ASX300 companies comply with this requirement … The main area of non-compliance is in the full reporting of performance requirements, mainly for the annual [short-term incentive] payment. (sub. 80, p. 68)

Similarly, RiskMetrics stated:

> Non-compliance with [section 300A(1)(ba) of the Corporations Act] is routine, especially in relation to annual cash bonuses, and is apparently not policed. RiskMetrics is aware of only a handful of listed companies … that disclose the actual performance conditions that had to be satisfied in order for bonuses to be paid for the prior year … the relevant government agency, the Australian Securities and Investments Commission, [should] more stringently police disclosure in this area … (sub. 58, p. 12)

Guerdon Associates acknowledged that commercial sensitivity may be a valid reason for non-disclosure in some instances, however it believed that requiring companies to seek exemptions from the Australian Securities and Investments Commission would be a better approach than (in its view) not enforcing the law. This would be consistent with the US, where exemptions are allowed, but are:

> … actively monitored and usually disallowed by that country's SEC. It would be difficult for a company to argue that such information is commercial in confidence as it pertains to a past fiscal period. (sub. DD119, p. 5)

ACSI submitted:

> There are companies that do not disclose the performance conditions attached to short-term incentives … ACSI is aware of the commercial sensitivities that arise in the disclosure of specific internal Key Performance Indicators or budget related information that is linked to annual bonuses. However ACSI believes that this can be overcome by an appropriate narrative on these issues. (sub. 71, pp. 8–9)

In view of such considerations, current legal requirements might not be appropriate. Indeed, mandated disclosure of actual hurdles could lead perversely to the adoption of hurdles that are less closely aligned with improving company performance, or even a reduction in the use of incentive pay. Nevertheless, companies should be encouraged to disclose as much relevant information as possible by including, as ACSI suggests (sub. 71), a narrative about commercially-sensitive hurdles and, where feasible, by disclosing them after the event.

8.3 Can disclosure requirements be rationalised?

Without a reduction in the range of information currently required to be disclosed, and given the inherent complexity of remuneration structures, remuneration reports will remain long and complex. Accordingly, a number of participants raised the possibility of streamlining current disclosure requirements with a view to focusing on core aspects of remuneration important for investors (including the Australian Institute of Company Directors, sub. DD149; the Australian Bankers' Association, sub. 70; the Joint Accounting Bodies, sub. 77; CGI Glass Lewis and Guerdon Associates, sub. 80; Chartered Secretaries Australia, sub. 57; Hay Group, sub. 85; the Law Council of Australia, sub. DD150; Mercer, sub. DD139, Woolworths, sub. 91; and KPMG, sub. 95).

For example, CGI Glass Lewis and Guerdon Associates suggested that:

> … some of the current disclosure requirements of section 300A of the Corporations Act provide nonsensical and irrelevant requirements for disclosure of many aspects of executive remuneration.
>
> A good example of such a requirement is section 300A(1)(e)(iv) of the Corporations Act which requires the disclosure of the value of options that have already lapsed … (sub. 80, p. 70)

Another requirement that might fall into this category is section 300A(1AA)(b), which requires discussion of the consequences of company performance for shareholder wealth. While obviously important for shareholders, it is not clear why this should be included in the remuneration report.

Potentially more wide-reaching areas for reducing the compliance costs associated with remuneration reports include:

- limiting the number of individuals whose pay is to be reported
- streamlining the regulatory framework.

Is the remuneration report covering the right people?

Given the twin objectives of disclosure of minimising conflicts of interest and providing information relevant to company risks and prospects, the appropriate focus of disclosure should be on individuals who can influence their own pay (that is, where there could be a conflict of interest) and on those whose behaviour could materially affect the performance of the company.

The Corporations Act (section 300A) requires disclosure of remuneration details for both key management personnel (as defined by accounting standards — see box 8.12) *and* the five highest-paid group and company executives. In practice, there tends to be a high degree of overlap between the two classifications.

Box 8.12 Accounting standards: key management personnel

AASB 124 requires remuneration disclosures for key management personnel, defined as 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity' (AASB 124, p. 10). It is up to each company to determine which employees fit within this definition.

BHP Billiton (sub. 45), the Joint Accounting Bodies (sub. 77) and CGI Glass Lewis and Guerdon Associates (sub. 80) questioned the need for inclusion of the five highest paid group and company executives as well as key management personnel. BHP Billiton suggested that the Corporations Act be aligned with the Australian Accounting Standards Board (AASB) standard AASB 124:

> We believe there is no sound basis for section 300A continuing to refer to the 5 highest-paid executives of the group and of the company. This aspect of section 300A derives from its introduction more than a decade ago, at which time there was no coherent interaction between section 300A and accounting standards. That is no longer the case … we believe section 300A should be aligned with AASB 124 and require disclosure only in relation to the key management personnel. (sub. 45, p. 2)

Pushing in the opposite direction, however, are calls in response to the global financial crisis to expand remuneration monitoring and disclosure of individuals responsible for risk-taking, such as traders in investment banks. In Australia, remuneration of such individuals will be captured by APRA's remuneration policy for financial services businesses. Given the special nature of the financial sector and APRA's supervision of it, it would not seem appropriate to additionally require public disclosure of remuneration of the subset of such individuals who work for such financial entities. Moreover, for non-financial companies, it is unlikely that any personnel other than key management personnel are routinely able to make unsupervised decisions that expose the company (or the broader community) to significant risks.

As indicated in box 2.5, the requirement for disclosure of remuneration of the five most highly-paid executives was introduced in 1998, with the addition of 'key management personnel' in 2004 in the context of the introduction of the remuneration report and non-binding shareholder vote. Given the objective of remuneration disclosure, it would seem that a focus on key management personnel would be appropriate. Such rationalisation would also make the Corporations Act provisions consistent with accounting standards.

In practice, confining disclosure to key management personnel is likely to have a negligible impact on disclosure by larger companies because their five highest-paid group and company executives typically are subsumed by the definition of key management personnel. Smaller companies are more likely to have fewer than five key management personnel, resulting in a reduction in their reporting requirement. Nonetheless, by definition, executives removed from the remuneration report would not have responsibility for managing or controlling the activities of the entity. (For example, one company has reported remuneration of its graphic designer.) Consequently, for these companies, confining obligatory reporting to key management personnel would reduce the compliance burden and the complexity of the remuneration report, without losing relevant information for shareholders.

Some participants questioned whether disclosure for all key management personnel was appropriate. KPMG considered that disclosure had created difficulties in recruiting to some positions due to privacy and security concerns (trans., p. 387 and sub. 95, p. 4). Privacy issues were also raised by CGI Glass Lewis and Guerdon Associates (sub. 80, p. 23). Moreover, it was suggested that shareholders were not interested in remuneration disclosure other than for individual directors and the CEO. According to KPMG:

> … the anecdotal evidence is that shareholders are overwhelmingly interested in the remuneration of only the directors (including the managing director/chief executive officer) … We recommend that disclosing entities should disclose the dollar value of remuneration components (eg short-term, long-term, share-based payments) for the individual directors (including executive directors and the CEO) only. (sub. 95, p. 4)

Such an approach would reduce the amount of detail in remuneration reports while still providing broad information about key management personnel other than the CEO and executive directors. Detailed reporting would only be required for those executives for whom there was scope for conflicts of interest (because of their board positions).

Further consideration and recommendations on the range of individuals to be covered by the remuneration report, and the reporting requirements for them, are presented in chapter 11.

Compliance with disclosure requirements

It is unlikely that removal of one or two items from remuneration reports would significantly reduce their length or the compliance burden associated with producing them. Any more substantial paring back of requirements would likely reduce the usefulness of the report to some investors and consultants, particularly proxy advisers whose comparative advantage is in interpreting and on-selling such detail. In other words, the usefulness of reports is likely better advanced through improvements in presentation and clarity of exposition than a reduction in reporting requirements.

That said, compliance costs might still be reduced by rationalising the regulatory framework for remuneration disclosure. Companies are currently required to comply with reporting requirements contained in a variety of sources — chiefly the Corporations Act, but also other 'black letter' instruments (such as the accounting standards) and 'soft law' (for example, the ASX Corporate Governance Council's guidelines). These regimes risk unnecessary duplication in reporting requirements.

The Corporations Act and Corporations Regulations

The Corporations Act and Corporations Regulations concurrently detail the requirements for remuneration disclosure (box 8.1). Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (subs. DD168 and DD170) submitted that many requirements currently contained in the Act could be transferred to the Regulations.

Under the proposal outlined in the joint submissions (and detailed in the annexe to this chapter), section 300A of the Corporations Act would give only a high level indication of what disclosure is necessary, with the specific reporting requirements referred to Regulations. This 'back to basics' approach would be designed to give effect to the original purpose of section 300A — to 'improve the capacity of shareowners to carry out their governance role by providing them with better tools to do so' (sub. DD170, p. 3).

Containing the details in one location has some appeal from a streamlining perspective. A further benefit cited by Allens Arthur Robinson et al. is that further amendments could be easier to undertake, which would provide greater flexibility to adjust to changing circumstances than would amending the Act. However, this could easily become a drawback as well — particularly if new complexities were introduced into the Regulations. (Recognising this, Allens Arthur Robinson et al. suggested an expert panel be constituted to monitor the ongoing operation of the relevant sections of both the Act and the Regulations.)

There is invariably a balance between provisions being contained in an Act of Parliament (the primary legislation) and the supporting Regulations (the administrative guidance on how legislation is applied). Determining what should be placed in an Act and what may be left to Regulations will depend on a multitude of factors, including the level of scrutiny that is warranted.

Accounting standards

Some inquiry participants identified potential benefits from consolidating disclosure requirements contained in accounting standards with the Corporations Act (Australian Institute of Company Directors, sub. DD149; Chartered Secretaries Australia, sub. DD147; CPA Australia, sub. DD148; Institute of Chartered Accountants, sub. DD146). While Australia's accounting standards are principally derived from international agreements, the standards sometimes include Australian-specific provisions. This occurs in the case of remuneration disclosure requirements, under AASB 124, with the requirement to disclose equity holdings being just one example (box 8.13).

Box 8.13 **Total company shareholdings**

While much of the focus of disclosure is on annual remuneration, numerous studies (for example, Gayle and Miller 2008) have shown that a more relevant indicator of the alignment between executives' actions and company performance is the proportion of their total wealth that is linked to company performance. Changes in wealth, and the potential for such changes, can significantly affect an executive's behaviour. For example, equity holdings can motivate an executive to improve company performance in order to increase shareholder value.

The appropriate equity portfolio will depend on the ability of executives to increase the share price, their risk aversion and time horizon — in other words, it tends to be specific to the company and executive. On the other hand, a very large equity holding in a company could in some circumstances influence a chief executive officer to adopt less risky strategies in order to maintain share value in the short term (for example, to preserve wealth as retirement approaches). This might suit investors with a similar consumption time profile, but might not be in the long-term interests of the company.

As equity holdings are not remuneration as such, the remuneration report is not required to include information on total company shareholdings for individuals named in the report. (Some companies do so of their own accord.) However, under requirements imposed by the AASB the notes to the financial statements must report for equity, the number granted, held at the start and end of the period, and received on exercise of options or rights. Further, section 300(11) of the Corporations Act requires similar information for directors as part of the annual directors' report. Having this information summarised in the remuneration report (rather than detailed in the financial statements) would provide a more complete picture of the extent to which executives incentives were aligned with the interests of the company and shareholders. Again, however, this would add to, rather than subtract from, the length of remuneration reports.

The Institute of Chartered Accountants suggested:

> In order to reduce the potential for duplication, the Institute would encourage the Commission to consider making a recommendation for the removal of all the Australian-specific paragraphs in this accounting standard (applying to companies and disclosing entities). If these disclosures are determined necessary by law, they could perhaps be included in the remuneration report or another relevant section within the Corporations Act. (sub. DD146, p. 5)

Further, the Institute of Chartered Accountants conjectured:

> … that if the accounting standard board was approached that they would be very happy to wipe all of those [Australian-specific] paragraphs and it is just a matter of the lawmakers working with the [AASB] in order to get the right result which is, 'Let us make it not complex, not complicated, let us remove duplication and simplify it.' (DD trans., pp. 78–9)

In principle, this approach appears attractive. There does not appear to be a clear reason why remuneration disclosure matters should be addressed by accounting standards rather than the Corporations Act. While sound accounting principles are critical for preparation of a company's financial statements, shareholder disclosure is not of itself an accounting exercise. Transferring requirements currently contained in the accounting standards to the Corporations Act or Regulations could streamline requirements without compromising the quality of disclosure currently maintained.

A code of practice?

Consolidation might also occur between some of guidelines issued by investor groups. One approach to this, advocated by the Australian Human Resources Institute, could be to adopt a code of practice for company remuneration policies (see box 9.6 in chapter 9).

While potentially improving the presentation of a company's remuneration policy, the code as proposed would also include specific requirements and/or boundaries on remuneration policy (and actual remuneration). Further, a code would provide more detail and generally be 'stronger' than existing 'soft law' requirements and non-regulatory guidelines.

As stated by the Australian Human Resources Institute:

> The code of remuneration practice should really have some bite. It should go into the real drivers, how the decision to set somebody's pay is referenced by the value of their job, where they sit in the market, the value of that person, the value they're expected to drive, and then the process by which it is put through some appropriate review filters one or two levels away. You don't find that in the codes I've seen. (trans., p. 139)

The risks of a compulsory code are that it would become overly prescriptive and inflexible. An alternative is to encourage boards to provide more informative explanations of the objectives and design of remuneration packages, including key parameters and assumptions about how the package will work, and how risks have been taken into account. This could give investors some comfort that all contingencies have been considered, such that the risks of the pay structure delivering excessively costly outcomes for the company have been minimised.

Consolidation under a single 'umbrella'?

KPMG proposed broader consolidation still, recommending that disclosure requirements be placed:

> … under the one umbrella, rather than having accounting standards, corporate governance principles, investor association guidelines and, even further, a plain English summary. … There [should] actually be a recommendation by the Commission to the government to rewrite the Corporations Act, specifically section 300A, with a view to picking up any principles that are in all of these other guidelines. (DD trans., pp. 39–40)

While companies face a range of obligations, it would be hard to contain all remuneration disclosure principles solely in the Corporations Act. For instance, the ASX Corporate Governance Council's system of 'if not, why not' disclosure is deliberately a non prescriptive regime, recognising the diverse nature of companies. This would be ill-suited to a 'black letter' framework. Similarly, it would be difficult to synthesise the various guidelines promoted by individual investor groups into the Corporations Act, given that such organisations might seek to emphasise different areas of remuneration in different (and potentially conflicting) ways.

It is unlikely that all disclosure-related requirements and guidelines can be located in a single set of rules. Nevertheless, some degree of streamlining appears possible — particularly the accounting standards, as discussed above. Options for consolidating disclosure requirements are discussed further in chapter 11.

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan (sub. DD170) suggested that some reforms to the Corporations Act since 1998 (when section 300A was introduced) have made remuneration disclosure more complex than was initially intended. This view, at least in part, drives their proposal to redraft section 300A (see annexe). It also contributes to their recommendation that an 'expert panel' be established to monitor the operation of section 300A of the Corporations Act and the relevant regulations.

Given the potential for unnecessary duplication, which can impose undue compliance costs on companies and undermine the readability and usefulness of remuneration reports, an 'expert panel' that draws upon the perspectives and experiences of companies, advisers, investor groups and regulators might help ensure that the architecture for disclosure is streamlined, such that appropriate information is clearly conveyed to shareholders at least cost to companies.

Annexe: Specific proposals from inquiry participants

In response to questions raised in the Discussion Draft, some participants offered detailed suggestions on how remuneration reports should be designed and on how disclosure requirements could be streamlined.

Remuneration report design

Ernst and Young (sub. DD136) provided the framework for what they considered an 'ideal' remuneration report. The structure for remuneration of executives would be:

- Overview/summary — a description of the remuneration framework, key details of approaches to incentive payments and any additional one-off payments, as well as details of any expected reviews or changes to future remuneration.
- Remuneration strategy — including a discussion of objectives, quantum and the mix of remuneration components (fixed pay, short- and long-term incentives).
- Short-term incentives — a description of the plan, including discussion of performance metrics (as they operate) and details of any equity grants.
- Long-term incentives — a description of the plan(s), including discussion of performance metrics (as they operate), vesting schedules and details of equity grants.
- Contractual arrangements — such as notice periods, sign-on arrangements, termination entitlements (including those paid out in the current year) and details of any guaranteed payments.
- Remuneration outcomes — 'actual' pay data for current and previous years.
- Performance and reward link — including rationale for the selection of performance hurdles, current short- and long-term incentive payments relative to maximum opportunity and rationale, historical short- and long-term incentive payments relative to key financial measures and rationale, and changes in executives' shareholdings in the company.

For non-executive directors:

- Non-executive director policy and outcomes — a description of the remuneration framework (including base directors' fees, committee fees and fee sacrifice schemes), noting any changes to the framework. This section would also include 'actual' pay data for current and previous years.

Under the Ernst and Young proposal, other details would be moved to the financial report — for example, the accounting values of remuneration for key management personnel (which would be aggregated, rather than individually reported as now), and a description of the methodology used to value equity-based payments. A key appeal of this approach is that 'the removal of complex accounting disclosures would make it easier to use plain English throughout the [remuneration] report' (Ernst and Young, sub. DD136, p. 2).

Ernst and Young notes that mandating the structure of remuneration reports would likely be impractical. Instead, it suggests changes to the Corporations Act and Corporations Regulations to remove unnecessary disclosure requirements, modify potentially beneficial requirements, and to add new requirements (table 8.1).

Redrafting section 300A of the Corporations Act

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed a 'simplification' of section 300A of the Corporations Act (subs. DD168 and DD170). Under their proposed redrafting of section 300A, the Corporations Act would require that remuneration reports contain a plain English summary of remuneration policies and the remuneration for each member of the key management personnel. The details of these arrangements would be transferred to regulation 2M.3.03 of the Corporations Regulations.

Table 8.1 **Proposed changes to disclosure requirements**

	Suggested change
Remove	• methods used to assess performance conditions • minimum and maximum values of bonuses and share-based awards in future periods • accounting disclosures regarding options (value of options exercised during the year, value of awards lapsed during the year, percentage of remuneration consisting of options) • description of long-term incentive plans that do not relate to current year grants • individual disclosures for the five highest paid executives if they are not key management personnel.
Modify	• description of performance and remuneration link • vesting percentages of bonuses and share-based payments • remuneration mix discussion • presentation of prior year individual remuneration data • share option and right disclosures.
Add	• actual remuneration outcomes • rationale for remuneration policy and mix • details of comparator groups and mechanisms to guard against 'extreme' incentive payments • termination payments disclosure.

Source: Ernst and Young (sub. DD136).

Under regulation 2M.3.03, the plain English summary would be designed to inform shareholders about:

- the use of fixed remuneration, short- and long-term incentives, and how they relate to the company's performance
- the use of comparator groups for benchmarking remuneration
- whether incentive schemes had been subject to any sensitivity analysis (measuring under what circumstances 'excessive' pay levels might emerge)
- how remuneration levels might be tempered in the event of 'extreme outcomes' resulting from formula-based contractual obligations (that is, how 'excessive' pay levels might be restrained should unexpected outcomes emerge)
- who is responsible for setting and implementing remuneration policies
- how the policies are evaluated, and against what criteria
- how aligned the policies are with the company's risk profile.

Disclosure of remuneration levels would cover:

- 'realisable' remuneration during the reporting period, including:
  - what proportion of the 'realisable' remuneration resulted from fixed pay, vested incentives or termination benefits
  - a description of any performance hurdles or other vesting conditions
- payments granted (reported fair value at grant date), including:
  - a description of any performance hurdles or other vesting conditions
- total shareholdings.

Remuneration levels would continue to be reported in tables, for which Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed standardised formats (box 8.14).

Arguing that section 300A of the Corporations Act had been 'corrupted' since it was introduced in 1998, Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan also proposed that an expert panel be established to monitor the ongoing operation of, and advise on any future amendments to, both section 300A and regulation 2M.3.03.

Box 8.14 **Presentation of remuneration**

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan suggested how tables should be used to present remuneration levels (sub. DD168, pp. 4–5).

'Realisable' remuneration

Name	*Position*	*Total amount of realisable remuneration*
…	…	…

Grant date fair value

Name	*Position*	*Fixed rem.*	*Short-term incentives*	*Long-term incentives*	*Termination benefits*	*Other benefits*	*Total rem.*
…	…	…	…	…	…	…	…

Total shareholdings

Name	*Position*	*Total shareholding*
…	…	…

9 Strengthening shareholder engagement

> **Key points**
>
> - Despite some initial scepticism and concern by business, introduction of a non-binding shareholder vote on the remuneration report appears to have fostered more productive engagement between shareholders and boards.
>   - Many boards have proven sensitive to significant 'no' votes and have amended executive remuneration arrangements in anticipation or in response.
> - However, there are cases where this appears not to have happened and there has been a more general rise in the average 'no' vote.
> - A binding vote on the remuneration report or elements of it (such as the company's remuneration policy or equity grants to executives) are options to strengthen shareholder powers. A binding vote, however, would pose significant practical difficulties and some risks.
> - There are various options to strengthen the consequences of a significant 'no' vote, while maintaining the integrity of the non-binding vote.
>   - Approaches include a requirement to provide a formal explanation of action taken in response or, in more extreme cases, for directors to stand for re-election.
> - Allowing directors and key executives to participate in the non-binding vote on the remuneration report, whether directly or as proxy holders, serves to weaken its signalling role.
> - The existing paper-based proxy voting system has a number of shortcomings, including the potential for 'lost votes'. Electronic proxy voting and a more robust and auditable system would enhance the integrity of voting arrangements.
> - There are some concerns associated with current proxy voting regulations, notably the practice of undirected proxies being voted by company chairs and the potential for 'cherry picking' of votes by non-chair proxies.

9.1 The non-binding vote in context

Shareholders in a company have the power to elect (and dismiss) the board, as well as to vote on matters where their interests could be compromised by directors acting in their own interests or in a manner that could diminish shareholder wealth. Accordingly, shareholders are given binding votes on directors' fees, on equity issues to directors involving dilution and on large termination benefits (box 9.1).

These rights accord with the principle that shareholder voting is 'an accountability device of last resort to be used sparingly' (Bainbridge 2005, p. 27). In other words, voting is not intended to provide a means for shareholders to interfere in the operational aspects of the company. Consistent with this, while shareholders have had a vote on the company's remuneration report for several years, this was made 'advisory' only.

9.2 How effective *is* the non-binding vote?

The non-binding vote on the remuneration report was introduced in 2004-05 as part of the Corporate Law Economic Reform Program (CLERP) process. Commentary on the draft provisions of the Bill stated:

> … it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives. In performing their function, boards need to be accountable for their decisions and shareholders need to be in a position to exercise their rights in an active and informed way. The provisions of the Bill are designed to achieve these objectives by promoting transparency … (Treasury 2003, p. 101)

In particular, the non-binding vote was expected to 'facilitate more active involvement by shareholders and improve the accountability of directors for decisions regarding remuneration' (Treasury 2003, p. 105).

The legislation broadly followed arrangements introduced in the United Kingdom in 2002. A European Commission directive for voting on remuneration policy has led to mixed responses by member countries (box 9.2).

What effect has it had?

The non-binding vote provides shareholders with an opportunity to signal their support (or otherwise) for the remuneration policy of a company, and thereby influence board decision-making about remuneration policy and executive pay.

Box 9.1 **Rules relating to shareholder voting**

When do shareholders vote?

Non-binding vote on the remuneration report — shareholders have a (non-binding) vote on a company's remuneration report (*Corporations Act 2001* (Cwlth), s. 250R).

Election and removal of directors — a company may appoint a director by resolution passed at a general meeting (s. 201G). Where a person has been appointed by other directors, shareholders must confirm the appointment at the next annual general meeting (s. 201H). A group of 100 shareholders or shareholders with 5 per cent of the votes that may be cast on the resolution may propose a resolution to remove a director (s. 203D and s. 249N).

Increase in director fees — an entity must not increase the total pool of non-executive directors' fees without shareholder approval (listing rule 10.17).

Director obtaining equity under an incentive scheme — an entity must not permit a director (or associate) to acquire equity under an employee incentive scheme without shareholder approval, unless the shares are purchased on-market (listing rule 10.14).

Total termination benefits exceeding 5 per cent of a company's equity — a company must ensure that no officer receives termination benefits, if the value of those benefits and the benefits that may become payable to all other officers exceed 5 per cent of the company's equity, without shareholder approval (listing rule 10.19).

Termination payments above an income threshold — a director or key executive must not receive a termination benefit without shareholder approval, unless the payment is less than the average of their base pay over the past three years (s. 250B).

The voting process

Shareholders' voting rights are exercised at company general meetings. A general meeting may be called by a director of the company, shareholders with at least 5 per cent of votes that may be cast at the meeting, or 100 shareholders.

A resolution must be decided on a show of hands, unless a poll is demanded. A poll may be demanded by 5 members, or members with 5 per cent of votes. The chair can also demand a poll, and has a duty to determine the 'will of the meeting'.

Under a show of hands, each shareholder has one vote; however on a poll, a shareholder has one vote for every share owned.

Under a show of hands, the company is not required to disclose the number of shareholders voting for or against the resolution; however, this is a requirement when a resolution is decided by a poll. Regardless of whether a poll or show of hands decides the resolution, the direction of proxy votes received must be disclosed.

While generally all shareholders can vote on resolutions, there are exceptions, usually when there is a direct conflict of interest. For example, directors cannot vote on resolutions to approve their own termination benefits or equity incentive schemes.

Sources: ASX listing rules; *Corporations Act 2001* (Cwlth).

Box 9.2 **Shareholder voting on remuneration in other countries**

Since 2002, the **United Kingdom** has required an ex-post, advisory shareholder vote on director pay similar to that subsequently adopted in Australia (Ferri and Maber 2009).

In 2004, the **European Commission** recommended that member states require that remuneration policy be an explicit item on the annual general meeting agenda and a vote be required if requested by shareholders representing at least 25 per cent of votes at the meeting (European Commission 2005).

Responses by member states have varied: **The Netherlands** and **Sweden** have introduced a binding vote on remuneration *policy* only; in **Italy**, shareholder approval of remuneration policy is now required for banks. **Denmark** and **Portugal** require a declaration of remuneration policy to be submitted to shareholders at the annual general meeting, but shareholder approval is not required (Ferrarini et al. 2009).

In the **United States**, additional requirements were placed on recipients of Troubled Asset Relief Program assistance in February 2009, including a requirement for an advisory shareholder vote on executive remuneration. Further, the July 2009 white paper on financial regulatory reform included a commitment to introduce non-binding shareholder votes on packages for senior executive officers and on golden parachutes more generally (US Department of the Treasury 2009).

The notion of an advisory, rather than binding, vote has attracted a great deal of discussion. Some regard it as flawed precisely because it is not formally binding and therefore seen as having no teeth or necessary consequence. Others see it as the ‘thin edge of the wedge’ for shareholder usurpation of the role of the board, and its introduction was actively resisted at the time by major business representative bodies (box 9.3).

The case for a vote essentially rests on a view that boards might be ‘captured’ by executives in pay matters, or at least not be sufficiently ‘arm’s length’ from them. From this perspective, the non-binding vote, coupled with enhanced remuneration disclosure, provides a vehicle for shareholders to hold directors to account by indicating their collective view — and, if necessary, expressing ‘outrage’ — constraining through such signalling the scope for otherwise excessive remuneration packages, without unduly reducing board discretion in devising pay arrangements.

In the United Kingdom, available studies have not found evidence that introduction of the vote has led to a reduction in the growth of executive pay, although there has been an increase in performance pay relative to fixed pay. One study suggests that this increase was more pronounced in companies that experienced substantial ‘no’ votes, particularly those with high remuneration levels prior to the vote’s introduction (Ferri and Maber 2009). The authors conclude that this is consistent with boards having responded to the shareholder vote.

Box 9.3 **Business groups were opposed to a non-binding vote**

The Australian Institute of Company Directors and the Business Council of Australia expressed opposition to the introduction of the non-binding vote on the following grounds:

> Proposing a shareholder vote on the remuneration report is tantamount to suggesting that decisions regarding the remuneration of executive management are a shared responsibility between board and the shareholders. Good corporate governance requires that boards take sole responsibility for their remuneration decisions. Shareholders, if they are unhappy with the board's performance, have the right to make their views known at the [annual general meeting] and to cast their votes against the re-election of the relevant directors … The introduction of an 'advisory vote' … will set a precedent for shareholder votes on other matters that are properly the province of boards … (AICD 2003, pp. 23–4)
>
> The Business Council does not … support the proposal for a non-binding vote on executive remuneration. The proposal is unnecessary and infringes the basic principle that '*it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives*'. (BCA 2003, p. 12)

Likewise for Australia, although it is difficult to ascribe movements in the rate of growth of executive remuneration to the non-binding vote alone, the period since its introduction has coincided with much greater use of performance-related pay and the adoption of more demanding performance hurdles such as relative total shareholder return, both of which have been strongly advocated by investor groups.

Many participants in this inquiry considered that the non-binding vote had encouraged increased engagement of companies with (mainly institutional) shareholders, and that boards are sensitive to votes against the remuneration report (box 9.4).

CGI Glass Lewis and Guerdon Associates commented:

> … directors of listed entities are highly sensitive not just to a report that is 'voted down' (by a majority vote against the report, which is very rare) but also to a significant 'protest' vote against the report (by even a quite small percentage of votes).
>
> The reason for this sensitivity is twofold. The first is a reputational issue; directors of listed entities are very sensitive to their reputations in the public domain … The second is the prospect that a potential further consequence of sufficient disapproval of a remuneration report is a binding vote against the re-election of the director … (sub. 80, p. 14)

Box 9.4 **Impact of the non-binding vote — views from submissions**

CGI Glass Lewis and Guerdon Associates stated that they had:

> … experienced a significant increase in dialogue instigated by [non-executive directors] on remuneration issues since the non-binding vote was introduced. … ten years ago engagement by listed entities with their key institutional shareholders was minimal. (sub. 80, p. 66)

Similarly, the Australian Council of Super Investors observed:

> … the introduction of a non-binding shareholder vote … has been the single biggest catalyst for improved levels of engagement … (sub. 71, p. 12)

Mercer noted that the vote had increased accountability and transparency:

> The non-binding vote … has allowed shareholders to express their views … and we believe has provided a higher level of accountability and transparency that has moved boards to look to better align remuneration practices … (sub. 41, p. 10)

BHP Billiton felt that the non-binding nature of the vote:

> … appears not to have limited the vote's effectiveness … there is no shortage of examples of Australian companies that have responded to a substantial 'Against' vote, by making changes to their remuneration practices. (sub. 45, p. 1)

While remuneration reports of larger listed companies typically receive overwhelming support, the 'no' vote has been rising over time on average, particularly since the Global Financial Crisis.

- CGI Glass Lewis and Guerdon Associates noted that 'the average level in a consistent sample of 'against' votes has almost doubled from 6 per cent to 10 per cent between 2006 and 2008' (sub. 80, p. 65).
- PricewaterhouseCoopers observed that the number of ASX100 companies receiving a 'no' vote greater than 20 per cent had risen from 3 per cent in 2006 to 12 per cent in 2008 (sub. 85, p. 15).

The most recent annual reporting season has brought a larger number of instances of companies receiving significant 'no' votes on their remuneration reports (table 9.1). Among the more significant:

- Transurban narrowly avoided having a majority 'no' vote on its remuneration report in 2009 (47 per cent 'no' vote), with shareholders citing poor long-term incentive hurdles, excessive sign-on bonuses for the new chief executive officer (CEO) and no disclosure of short-term incentive hurdles as reasons for voting against the report (Speedy 2009). This followed rejection of its 2008 remuneration report by shareholders (59 per cent 'no' vote) due to concern over the size of its CEO's remuneration package despite poor company performance and the lack of disclosure of short-term incentive hurdles (CGI Glass Lewis and Guerdon Associates, sub. 80, p. 131)

- Qantas received large ‘no’ votes in both 2008 and 2009 (41 and 43 per cent respectively), apparently in response to the size of its CEO’s remuneration package. In 2008, the total package was $12 million. On his retirement the following year, the CEO received $11 million for nine months with the company, including a payout of $3 million to compensate for changes in superannuation tax laws (O’Sullivan 2009).

Table 9.1 **Substantial ‘no’ votes on remuneration reports, 2009**

Company	*No vote*	*Index*
Abacus Property Group	31%	ASX200
Aspen Group	48%	ASX300
Avoca Resources	26%	ASX200
Babcock and Brown Infrastructure	32%	ASX200
Bendigo and Adelaide Bank	32%	ASX100
Cabcharge	45%	ASX200
Challenger Financial	29%	ASX200
Clough	36%	ASX300
Crane Group	43%	ASX200
Dominion Mining	37%	ASX200
Downer EDI	59%	ASX100
Energy Developments	60%	ASX300
Kingsgate	52%[a]	ASX200
Lend Lease	42%	ASX100
Macmahon Holding	28%	ASX200
Nexus Energy	27%	ASX200
Novogen	81%	ASX300
NRW Holdings	53%	ASX300
Qantas	43%	ASX50
Ramsay Health Care	32%	ASX200
Riversdale Mining	25%	ASX200
Sims Metal Management	29%	ASX100
St Barbara	58%	ASX200
Straits Resources	48%	ASX200
Transurban	47%	ASX50
United Group	49%	ASX100
Western Areas	56%	ASX200

[a] Carried on a show of hands.

Source: Company announcements.

Chartered Secretaries Australia (CSA) conducted a survey in 2005 of company secretaries in the top 200 Australian companies (CSA 2005). On the question of *when* directors should take notice of shareholder concerns, around 90 per cent of respondents considered that a 20 per cent ‘no’ vote should prompt a response from the board. Only 1 per cent of respondents felt that a majority ‘no’ vote was required before boards should react.

There have been numerous examples of remuneration arrangements being amended in response to minority as well as majority ‘no’ votes. For example:

- Following its annual report in February 2009, QBE Insurance made changes to its remuneration plans after 23.5 per cent of shareholders voted against its remuneration report (Johnston 2009).
- In 2007, Telstra received a majority vote (66 per cent) against its remuneration report. At the time, the head of Telstra’s remuneration committee suggested proxy groups had no expertise in remuneration practices, and that Telstra could not renege on contracts, and therefore the 2007 arrangements went ahead as proposed (Alberici 2007). However, Telstra engaged with its shareholders and changed its remuneration practices by the 2008 remuneration report, which received resounding approval (SBS 2009).
- According to Wesfarmers (which received a ‘no’ vote of 51 per cent against its 2008 report): ‘Wesfarmers has taken the ‘no’ vote seriously and is addressing a number of the issues that were subject to criticism …’ (sub. 65, p. 2). Wesfarmers received strong shareholder approval on its 2009 remuneration report, with 90 per cent of shares voted in favour of the report.
- In 2008, Boral received a majority vote (58 per cent) against its remuneration report. Shareholders were apparently concerned that the CEO’s remuneration was targeted at the upper half of Boral’s peer group, despite Boral being one of the smallest companies in the group, and that there had been an increase in bonuses despite poor profitability. In 2009, no short-term incentives were granted and Boral ‘explained, in its 2008-09 Remuneration Report, the fundamental review undertaken by the Board and the Remuneration Committee of Boral’s remuneration practices and policies and set out in detail the steps taken to address shareholder concerns’ (sub. DD123, p. 1). Boral’s 2008-09 remuneration report received a 93 per cent approval vote.
- Suncorp-Metway’s 2008 remuneration report received a 32 per cent ‘no’ vote, largely due to high bonuses and pay rises to senior executives despite poor company performance (Walsh 2008). In 2009, Suncorp-Metway did not pay any short-term incentives and froze base pay for both directors and senior executives, which resulted in 96 per cent approval of the remuneration report.
- Following a 43 per cent ‘no’ vote in 2008, Toll restructured its remuneration arrangements, including freezing base pay and moving towards annual

shareholder approval for the CEO's long-term incentive (ABC 2009). The 2009 report received 85 per cent approval.

Many of those business groups which were initially sceptical of the vote now concede that it has been an effective vehicle for improving engagement between companies and shareholders (for example, the Australian Bankers' Association, BHP Billiton, Wesfarmers and Macquarie Group). This assessment is shared by institutional and retail investors (the Australian Council of Super Investors (ACSI) and Australian Shareholders' Association (ASA)), and remuneration consultants and proxy advisers (CGI Glass Lewis, Guerdon Associates, Mercer and Hay Group).

It is recognised, however, that there may have been some costs, including greater pressure on companies to implement pay structures that meet rules of thumb — such as one-third base pay, one-third short-term incentives, one-third long-term incentives, or incentives that are linked to relative total shareholder returns. As discussed in chapter 7, there are risks in 'tick-the-box' approaches that can serve to standardise executive pay arrangements across different companies. That said, boards can reduce such pressures by explaining more clearly how arrangements will promote company and ultimately shareholder interests.

Yet while companies generally respond to significant 'no' votes, there is no formal obligation on them to engage with shareholders or, indeed, respond in any way. As RiskMetrics noted:

> That's not to say that there isn't scope for improvement … The non-binding vote … has a disadvantage in the sense that there may not be an immediate consequence but the price of shame sometimes actually does get company directors to respond and that's certainly something that we've observed … Of course you run the risk in a non-binding environment that you will encounter boards or individuals without shame for whom there is no remedy. (trans., p. 362)

Although the majority of boards of major companies have generally responded adequately to shareholder concerns with the remuneration report, some participants felt that there was scope for further improving responsiveness across the breadth of public companies. For example, there have been some recent examples where little response has been evident, with some companies receiving consecutive significant 'no' votes on their remuneration reports (see section 9.3 and table 9.2 below).

Furthermore, the vote on the remuneration report is 'binary' — that is, either for or against — which can blur the signal to boards. There is a range of proposals to 'strengthen' the non-binding vote in the sense of making a significant or majority 'no' vote have tangible consequences. Some participants have also called for the vote to be made binding, while others support the introduction of binding votes on particular aspects of the remuneration report, such as equity grants and the company's remuneration policy. These options are explored below.

A binding vote on the remuneration report?

Several participants called for the vote on the remuneration report to be made binding. For example, the Australian Manufacturing Workers' Union stated:

> The Commonwealth could make amendments to the *Corporations Act 2001* that would enhance shareholder democracy. Shareholders could be given a full right of veto over a board's decision on executive compensation … (sub. 44, p. 12)

Such a change could significantly increase the influence of shareholders, with the potential to recalibrate the roles of shareholders and their agents, company boards. Effectively, shareholders could determine executive pay.

The remuneration report summarises remuneration arrangements already negotiated and contracted with executives. If a majority of shareholders voted against the report, arrangements would have to be altered or terminated. While remuneration arrangements could be made subject to shareholder approval, this would create uncertainty for executives who might instead take jobs offering more certain outcomes (for example, overseas or with non-listed entities). A board's lack of authority could be particularly problematic when seeking to engage an external candidate. Overcoming such uncertainty would require either shareholders effectively negotiating remuneration arrangements (which would be impractical), or shareholder-approved prescriptive guidelines for boards to follow in remuneration negotiations, which would undermine their need to be able to exercise discretion.

The question is whether such a re-balancing would be desirable. BHP Billiton observed that:

> One of the most important functions of a Board is to hire, monitor and where necessary replace the CEO. Giving the Board the responsibility, and holding it accountable, for senior executive remuneration is a logical extension of that primary function. (sub. 45, p. 1)

The case for shifting responsibility for remuneration setting, or significantly constraining the board's decision-making authority in this area, effectively hinges on demonstrating that the public company model is fundamentally flawed, with no possible remedy through enhanced corporate governance. Most participants, including investors and shareholder interests, did not consider this to be the case. ACSI noted that it:

> … does not support the notion of a binding vote on remuneration reports … the current legislative provisions and rights of shareholders are appropriate. (sub. 71, p. 12)

The ASA said it:

> … would not support a binding vote on remuneration for the reasons that it is not practical and is unlikely to be helpful given that shareholders will have differing views on what is appropriate in terms of remuneration. (sub. 54, p. 16)

Put another way, most participants accepted that the board structure is an effective, if inevitably imperfect, mechanism for representing the interests of diverse and ever-changing shareholders. Indeed, in light of the potential for a binding vote on the remuneration report to create instability and diminish shareholder wealth, it is conceivable that investors would be less inclined to vent 'outrage' by voting against the report.

A binding vote on equity grants or remuneration *policy*?

The non-binding vote applies to the remuneration report in its entirety. A number of participants felt that this muted the usefulness of the vote, because it was unclear which aspects of remuneration caused shareholder concern. The CSA considered that:

> Shareholders who approve of a company's overall remuneration strategy might feel compelled to vote against it because they dislike a single element. (sub. 57, p. 16)

Regnan observed:

> It is our view that the current non-binding vote does not require strengthening, as it is already communicating shareholders' dissatisfaction with board decisions on remuneration. However a key limitation of the non-binding vote is that it allows for neither precision nor constructive feedback to the board. (sub. 72, p. 9)

However, the lack of a clear voting signal can be and apparently is being addressed through pre- and post-vote discussions between shareholders and proxy advisers and boards. Nonetheless, some participants urged separate binding resolutions on aspects of the report: specifically equity grants and the remuneration policy.

Voting on equity grants

Due to potential conflicts of interest, shareholders currently receive a binding vote on the issuing of equity to directors (including executive directors). Prior to 2005, Australian Securities Exchange (ASX) listing rule 10.14 required shareholder approval for a director to acquire securities under an employee incentive scheme. Following a review by the ASX, this rule was amended in 2005 to exempt securities purchased *on*-market from requiring shareholder approval. When the review commenced in 2004, the proposed amendment referred to on-market purchases through *salary sacrifice* arrangements. Reference to these arrangements was omitted from the final version. Some shareholder groups raised concerns with the amendment (box 9.5).

Box 9.5 **Listing rule 10.14 — views from submissions**

The ASA suggested that listing rule 10.14 could be exploited by companies:

> The ASX listing rules currently require shareholder approval of equity based incentive schemes for directors when new equity is issued, but not where the equity is purchased on market … It is not unusual for companies to state that if approval is not forthcoming, shares will be purchased on market or the amounts paid in cash. (sub. 54, p. 17)

Fidelity International also expressed concern with current arrangements:

> The amendment grants companies an exemption from this requirement if it intends to purchase on-market … In our experience, no other developed capital market contains such an exemption … we recommend this exemption be repealed. (sub. 83, p. 5)

ACSI commented:

> Listing rule 10.14 however has emerged as a loophole. Boards wishing to avoid binding votes on their long-term reward system can by using shares bought on market avoid a binding vote on:
>
> • the number of shares;
>
> • the terms under which performance is to be measured;
>
> • the vesting arrangements.
>
> … In our opinion, amending listing rule 10.14 should cover all equity-based long-term incentives to directors. ACSI agrees with the preservation of its use in relation to bona fide salary sacrifice, that is sacrificing fixed salary. (sub. DD156, pp. 2–3)

Similarly, RiskMetrics submitted:

> … any grant of equity securities to members of key management personnel also be subject to shareholder approval. (sub. 58, pp. 7–8)
>
> A non-binding vote is clearly not adequate protection against the dilutive potential of on-market purchases for insiders using company funds and it is not clear why shareholders' rights to protect themselves against insider share acquisitions on preferable terms should not be restored. (sub. DD164, p. 2)
>
> [Listing rule 10] exists to protect shareholders of the company from having their company taken away on unfair terms by insiders in privileged positions … This can happen through the issue of new shares on terms that are not available to any other shareholder to a director, or through the company spending its own money to buy shares for a director and then transferring it to them for nothing. Either way, voting and dividend rights pass to insiders on terms that are unavailable to anyone else. (DD trans., p. 246)

RiskMetrics also suggested that the timing of share purchases by a company could in some cases represent insider trading. (DD trans., p. 255)

These concerns relate to:

- the listing rule representing a 'loophole', with companies able to purchase shares on-market and thus avoid the need for shareholder approval
- the rule not covering senior (non-director) executives
- the exemption applying more broadly than for salary sacrifice arrangements
- the risk of insider trading.

Despite some participant concerns with listing rule 10.14, the rule is working as intended to apply in circumstances where the issue of shares would have a dilutive effect on shareholders' stake in the company. In the ASX's September 2004 exposure draft, it identified that 'the amendment is proposed to provide a carve-out for circumstances where securities acquired for related parties under an employee incentive scheme are acquired on market, and so do not compromise the policy rationale for the rule [of requiring shareholder approval for any dilution of their holdings]' (ASX 2004, p. 45). A note to the proposed listing rule stated that 'salary sacrifice includes incentive payments' (ASX 2004, p. 45).

The ASX has more recently commented on the reasoning behind listing rule 10.14:

> … shareholder approval should be required for any issuance of new shares to directors because even though the dilution of shareholders interests may be less than would otherwise warrant shareholder approval, the conflicted position of directors warrants a shareholder vote even in these circumstances. (sub. 64, p. 7)
>
> … the requirement for shareholder approval under listing rule 10.14 … is primarily concerned with the dilution of shareholders' capital interests. Securities purchased on market do not involve shareholder dilution because the shares have already been issued … (sub. DD142, p. 6)

The CSA similarly commented that the purpose of the rule is to prevent widespread dilution of shareholder equity, hence the exemption for on-market purchases:

> Most of the reason for regulating remuneration by shares is the dilution effect on shareholders. If the shares are already issued, then you don't have the dilution effect. So what you have is a company simply going out to the market and purchasing shares … It doesn't have a dilution effect. (trans., p. 120)

Further, the Parliamentary Joint Committee on Corporations and Financial Services, while acknowledging concerns with the amendment, observed that:

> … the rule is designed to prevent the dilution of shareholder value through share issues to directors. In this context, the exemption for shares purchased on market is reasonable. However, the committee acknowledges concerns about the potential for improper activities that may stem from the exemption. (2008, p. 64)

Even though, prior to its amendment, listing rule 10.14 may have appeared to cover on-market purchases, in practice this was not the case. The ASX commonly granted waivers from the listing rule to companies that acquired shares on-market for long-term incentive schemes. Between February and November 2005 (when the amended listing rule took effect) 32 waivers were granted, the majority of which related to shares acquired on-market. The ASX typically granted waivers where there was no concern that the recipient would acquire the equity on advantageous terms (generally because the recipient was required to meet performance hurdles) and no dilution concerns.

Some companies nevertheless have voluntarily put equity-incentive plans involving on-market share purchases for directors or executives to a shareholder vote. One example is AMP, which sought shareholder approval for the CEO's long-term incentive plan. Shareholders approved the 2007-08 long-term incentive equity grant, and AMP intends to seek shareholder approval for the CEO's 2009 long-term incentive grant. However, the company indicated that if shareholder approval is not given, a cash payment will be made instead (assuming performance hurdles are satisfied) (AMP 2009). ACSI noted other examples of companies seeking shareholder approval for equity plans involving on-market share purchases, including Boral, GPT, Paperlinx, Qantas and WorleyParsons (sub. 71, p. 9).

The risk of insider trading has also been raised. Specifically, it is argued that some companies may time on-market acquisitions to take advantage of favourable share prices and 'inside' information. However, insider trading is not exclusively related to equity grants or executive remuneration, and is addressed separately under the Corporations Act. Requiring shareholder approval of equity grants would be a very blunt and indirect way of addressing the risk of insider trading. Further, it would not address the timing of equity grants — under listing rule 10.15A, a company has up to three years to grant equity under an incentive scheme following shareholder approval.

If shareholders were given a binding vote on all equity grants — the preferred position of ACSI and RiskMetrics — this would represent a vote on a large part of the remuneration of key executives, particularly in larger companies. Long-term incentives on average account for around a third of total remuneration for CEOs (chapter 3). Some companies are also increasingly providing some of their short-term incentives in the form of company shares. A binding vote for shareholders on a significant proportion of total remuneration would impinge on a key area of director responsibility, and may perversely lead to a movement away from incentive-based pay. Given remuneration fungibility, targeting only one aspect of remuneration with a binding vote could lead to other forms of pay being adopted instead. This issue was raised by Regnan, who submitted that a binding vote on all equity issuances may:

> … drive remuneration away from equity-based incentives to cash-based incentives, thus reducing alignment between executives and the interest of long-term company owners. (sub. DD159, p. 14)

Some participants similarly argued that the vote on equity awards in other jurisdictions has had perverse effects. Hay Group stated:

> An example of what can go wrong with too much shareholder influence can be found overseas where there is insistence of many UK institutional investors on approving only [long-term incentives] with tough performance conditions. This has been counter productive and has had unintended consequences. It has led to many plans with a less than 50 per cent chance of paying out and an even lower chance of a meaningful payout — not usually an effective incentive. (sub. 84, p. 27)

In the United States, a study by Ng, Wang and Zaiats (nd) suggested that company behaviour has been influenced by the strengthening of shareholder approval of equity compensation plans from 30 June 2003:

> … evidence suggests that companies are choosing not to amend the existing plans and not to adopt the new ones, thereby eliminating the need to put these plans to a vote. (p. 11)

Thus, while removing the exemption for on-market purchases, or confining the exemption to 'traditional' salary sacrifice arrangements, would reduce the potential for conflicts of interest for directors, the downside might be discouragement of equity-based incentive arrangements for executives in favour of cash salary. As in AMP's case, if the equity grant is rejected, the executive is likely to be paid in cash instead. In this light, the current focus of listing rule 10.14 solely on dilution of shareholder equity would appear appropriate.

A vote on remuneration policy?

Instead of introducing a non-binding vote on the remuneration report, the Netherlands and Sweden have introduced a binding vote on remuneration *policy*. Some participants proposed that Australia introduce a similar vote. In Australia's case, a vote on remuneration policy would be additional to the annual advisory vote on the remuneration report, with the agreed policy providing a framework against which to assess the remuneration report.

As discussed in chapter 8, The Australian Human Resources Institute (AHRI) went further, proposing that all company remuneration policies should comply with a code of practice and that compliance of the annual remuneration report with the formalised policy should be audited, with any qualifications by the auditor automatically triggering a shareholder vote:

> … the board should put up their detailed plans and proposals for executive remuneration to shareholders based on [a] code of practice … and that should be subject of a binding vote. Once that's done, then … subsequent remuneration reports could be non-binding, but … those reports should be audited as to conformity to the plan that shareholders have approved. If there are … qualifications in the audit … then those qualified matters should be excised and automatically triggered to a binding vote.
>
> … [the company would have] freedom to vary [the remuneration policy], but then it would be subject to another binding vote. (trans., pp. 131–2)

More details of AHRI's proposals are contained in box 9.6. While obtaining shareholder endorsement for remuneration policy could lead to a degree of 'buy-in' by shareholders, and set out an agreed framework within which boards would have authority to set executive remuneration, it is not clear that this would achieve better outcomes than the present arrangements.

- Shareholders change over time and today's cohort might not support the policy agreed to a few years earlier.
- Remuneration policies might be written in very general terms so that they have little practical impact.

This latter point was noted by PricewaterhouseCoopers, who suggested that in countries that have a binding vote on remuneration policy, the detail contained in the policy is limited:

> … however to our knowledge only the Netherlands and Sweden require shareholders to have a binding vote on the remuneration policy. Even in these circumstances, we understand the detail provided in the remuneration policy is limited. (sub. 85, p. 10)

To preclude this, policies could be required to comply with a code of practice as suggested by AHRI. The code could ensure that remuneration policies focus on specific areas important to shareholders. However, in practice, it may be difficult for a code to strike the right balance between promoting meaningful remuneration policies on the one hand and, on the other, avoiding being overly prescriptive about how companies should structure pay. AHRI's proposal for remuneration practices to be audited (presumably by external remuneration practitioners) against the policy, suggests that the code and therefore policies would need to contain more than high-level principles (which is what remuneration reports currently seem to provide, as illustrated by box 8.3 in chapter 8).

Box 9.6 **Australian Human Resources Institute proposals**

AHRI's preferred model incorporates:

- a 'two level away' rule — for example, CEO pay would be recommended by the remuneration committee, for approval by the full board
- board approval for all share and option schemes
- for very senior executives, the board seeking outside advice and data.

It stated that:

> It would be possible to extend these principles into a Code of Remuneration Practice … (sub. 49, p. 6)

AHRI also recommended:

> A binding vote on a company's prospective remuneration plans and programs for say the next five years including a transparent alignment of the former to a Remuneration Code of Practice … [and] in subsequent years a non-binding vote on the annual [remuneration report] … which could also be the subject of a quality assurance audit certificate that such plans are being pursued fairly and diligently. (sub. 49, p. 6)

Where an aspect of remuneration was subject to a qualified audit, these amounts should be held in reserve subject to a binding vote by shareholders (sub. 49, p. 6).

AHRI elaborated on these recommendations at the public hearings, to the effect that the code could include quantitative information which placed a value on the role to be performed:

> I think if you focus the core remuneration decisions on the size of the role then you are being equitable to the individual and to the market … So within the framework I am advocating you can pay the top performers and structure their remuneration so they're being treated fairly and if they're a really top performer you know what they should be paid at the upper end. (trans., p. 135)

In a supplementary submission, the National President of AHRI outlined some additional requirements:

- information on 'operation critical executives' (in addition to key management personnel), albeit with reduced disclosure requirements for these executives
- board assessment and reporting on the riskiness of the company's pay structures
- a short-form remuneration report
- disclosure of remuneration skills and experience on the board
- the inclusion of an adviser code of conduct to cover remuneration and proxy advisers (AHRI, sub. 104).

While the binary advisory vote is not a perfect mechanism for gauging the opinion of shareholders on the remuneration report, it has promoted constructive engagement between shareholders and boards. Further, it has only been in operation since 2005. Though supporting a remuneration code, AHRI acknowledged that more time would be required in order to judge the effectiveness of the non-binding vote:

> Whilst AHRI still sees merit in such a Code forming a very useful part of a future governance regime, we accept the Commission's perspective that the best next steps for Australia are to give the non-binding remuneration report framework more time to work, and also to focus on streamlining and improving its content … (sub. DD114, p. 6)

With options to improve disclosure and engagement around the advisory vote, it is not apparent that a binding vote on remuneration policy is required or desirable.

9.3 Elevating the consequences of a significant 'no' vote?

Currently, boards receiving significant 'no' votes face reputational consequences and the risk of being voted against at re-election if they do not respond to shareholder concerns. In this regard, CGI Glass Lewis commented that it:

> … applies a policy of recommending against the re-election of a director who is the chairman of a remuneration committee that puts out a remuneration report that CGI Glass Lewis regards as seriously sub-par. (sub. 80, p. 14)

And the ASA's new executive remuneration policy (to apply from 2009-10) states:

> Where there has been a significant, for example 20 per cent, vote against a Remuneration Report by independent shareholders and the board concerned has failed to take appropriate corrective action, the ASA intends to vote undirected proxies against the re-election of any of the directors at the next AGM of that company. (ASA 2009, p. 2)

In addition to increased activism by shareholders, several participants favoured measures to strengthen the consequences of a significant 'no' vote to ensure responses from boards. One option would be to require the board to report back to shareholders with an explanation of how shareholder concerns have been addressed or, if they have not been addressed, why not. Other possibilities include requiring that the chair of the board, entire board or remuneration committee stand for re-election following one, possibly two 'strikes' — where the trigger is either a majority or some other threshold 'no' vote.

The ASA argued for a requirement that the chair of the remuneration committee at the time of a majority 'against' vote, automatically face re-election at the next annual general meeting of the company (sub. 54). This is similar to a recommendation of the recent Walker review of UK banking institutions, although that review proposed a 25 per cent 'no' vote trigger rather than a majority (Walker 2009, p. 22).

Requiring an explanation

While many boards already explicitly address shareholder concerns in their remuneration reports, formalising this as a requirement where a remuneration report receives a significant 'no' vote would extend the practice where it may be most needed to promote shareholder trust and engagement. Such a response could also be encouraged as best practice even where reports attract a small but non-trivial level of protest. Such an explanation could be especially helpful to retail investors, who would be unlikely to have the benefit of discussions with board representatives on remuneration matters.

Confining mandatory explanations to remuneration reports that received less than 50 per cent support would mean that, on current voting patterns, relatively few companies would be compelled to report their response. A lower 'no' vote trigger (for example, a requirement for 75 per cent to be in favour, in line with the level of support required for special resolutions) would have greater reach, and arguably better align with voting levels commonly accepted as indicative of serious shareholder concern about remuneration.

Directors to face re-election?

A further option to strengthen consequences would be for directors to face re-election following a substantial vote against the remuneration report. Such a consequence would counter the potential for any board complacency on the remuneration report vote attributable to its non-binding nature and provide stronger incentives to engage with shareholders. Further, such a provision would be expected to put most pressure on recalcitrant boards.

The sanction of an automatic director re-election following a substantial vote against the remuneration report undoubtedly would further focus directors' attention on executive remuneration and shareholder demands. But enhancing shareholder influence must be balanced against the desirability of maintaining the board's authority to set executive pay: it would not be desirable to allow the non-binding vote to become a de facto binding vote on remuneration, for reasons elaborated earlier. Moreover, if investors felt that the consequences of a significant 'no' vote could destabilise the company (and thus the share price), they might shy away from expressing discontent about executive pay in the first place. Hence it is crucial that any measures to strengthen the consequences of a significant level of dissatisfaction with executive remuneration are carefully designed, well-targeted and proportionate.

In this context, an automatic requirement for one or all directors to face re-election following *one* negative vote on the remuneration report would mean that directors would potentially be penalised even if they had listened and responded to shareholder concerns. In other words, they would face a sanction even if they did the 'right' thing and the subsequent remuneration report was strongly supported (as has often been the case). Of course, if directors had responded to the satisfaction of shareholders, they would likely be re-elected. The vote in this case would be unnecessary yet potentially destabilising. Perversely, this possibility could heighten the potential for a 'chilling' effect on the vote in the first place. Either way, the objective of fostering better engagement between boards and shareholders would be subverted rather than promoted.

A 'two strikes' approach?

While the non-binding vote appears to be working well overall and has been a catalyst for increased company and shareholder engagement, there are instances where companies have received significant consecutive 'no' votes on their remuneration report. As shown in table 9.2, companies receiving consecutive no votes of 25 per cent or more in 2008 and 2009 represent about 5 per cent of the ASX200. In addition, as noted earlier, the average level of 'no' votes has been gradually increasing, with a small, but significant number of large companies receiving majority 'no' votes in the most recent reporting season (table 9.1).

A so-called 'two strikes' approach — that is, an automatic requirement for director re-election if two consecutive remuneration reports attracted substantial disapproval — has greater potential to target boards that are apparently consistently unresponsive while maintaining the integrity of the non-binding vote. Such an approach would complement a formal requirement for an explanation of the board's response to the first 'no' vote. If shareholders judged the response or explanation unsatisfactory, they could then seek to remove the board or particular directors.

However, a number of participants observed that a two-strikes approach could bring the potential for excessive shareholder influence on pay decisions, or board instability and with it the potential for a chilling effect on voting against the remuneration report. Some other participants discounted these concerns (box 9.7).

Table 9.2 **Consecutive 'no' votes > 25% on remuneration reports and voting results for least popular director seeking re-election**

ASX200 companies

	2007		*2008*		*2009*	
	Rem report 'no' vote	*Director 'for' vote*	*Rem report 'no' vote*	*Director 'for' vote*	*Rem report 'no' vote*	*Director 'for' vote*
	%	%	%	%	%	%
Abacus Property			50	85	31	73
Babcock and Brown Infrastructure	32	78	30	91	32	67
Challenger Financial			37	81	29	95
Crane Group	36	96	34	100	43	98
Qantas			41	98	43	96
St Barbara			61	100	58	100
Suncorp/Suncorp-Metway	43	98	32	91		
Toll Holdings	32	100	43	100		
Transurban			59	66	47	100
United Group			38	97	49	99
Western Areas			27	96	56	58

Source: Company announcements.

Conflating feedback and sanctions?

Arguably the key concern with director re-elections is that the potential for board disruption and directors becoming distracted from performing core oversight functions could discourage shareholders from voting against the remuneration report, particularly where a first strike has already been triggered (a 'conflation effect'). As table 9.2 demonstrates, shareholders apparently deliberately distinguish between concerns with remuneration and broader concerns about the performance of the board, as rarely — if ever — has a vote against directors been anywhere near the level of dissatisfaction expressed about remuneration reports. Participants have suggested that a mechanism that tied the two could therefore make shareholders wary of voting against a remuneration report. As Freehills noted:

> While institutional shareholders have been willing to send a protest vote through the non-binding advisory vote (because they are able to do so without damage to the company and their investment), they are not likely to do so where that 'protest' vote could actually result in a board spill. This will, in effect, 'silence' institutional shareholders who will not wish to risk a board spill. (sub. DD130, p. 3)

Box 9.7 **Responses to the 'two strikes' draft proposal**

In support of the proposed 'two strikes' approach, ACSI stated:

> ACSI supports the proposal that calls for greater accountability and potential Board re-election if there are at least 25% of 'no' votes on a remuneration report in the first year and at least a 50% 'no' vote in the second year.
>
> We believe that these provisions would, for the majority of companies in the ASX200, remain largely irrelevant and would only act as deterrent for recalcitrant companies that continue to ignore shareholder concerns on remuneration. We consider this mechanism to provide a potential consequence for 'inaction' on the part of companies who do not seek to engage with shareholders on substantive remuneration issues. (sub. DD156, pp. 8–9)

Similarly, Regnan submitted:

> Even if instances of a second strike occurring are few, it is anticipated that the mere threat of the consequences of a second strike will be enough to drive further company engagement with shareholders on remuneration. (sub. DD159, p. 13)

Andrew Murray noted the 'two strikes' proposal would encourage board responsiveness to shareholder concerns:

> Recommendation 15 should have a useful chilling effect on boards that continue to ignore significant shareholder sentiment.
>
> I concur with Recommendation 15, in that it will positively affect board conduct and increase board responsiveness to shareholders views on remuneration. (sub. DD112, p. 7)

However, other participants, including the Business Council of Australia, Chartered Secretaries Australia and KPMG opposed the 'two strikes' proposal:

> The proposal elevates the issue of the remuneration report above other key strategic issues to be decided by the board. The recommendation puts inappropriate power in the hands of minority shareholders and could be used for ulterior motives. These concerns are particularly acute should a low threshold be adopted for the second 'trigger'. (BCA, sub. DD152, p. 7)
>
> Clearly it is desirable to have a mechanism available to shareholders to express their dissatisfaction with the board … However, given the extremely negative consequences that could arise from an exercise of the proposed shareholder power to dismiss the entire board at one meeting … CSA believes that shareholders will be very reluctant to exercise the proposed power … CSA believes that it is unlikely that it will achieve the outcome intended. (CSA, sub. DD147, p. 11)
>
> The requirement for a full re-election of the board could be a costly and de-stabilising process. If directors were being turned over at a high rate, a company may suffer significant strategic damage due to a lack of continuity at board level … The potential cost and strategic damage that can arise in respect of a full board re-election can also result in a real risk that shareholders may be less inclined to vote 'no' in respect of a remuneration report. (KPMG, sub. DD145, p. 7)

RiskMetrics expressed similar concerns, noting that a 'two strikes' approach:

> … could potentially dilute the non-binding vote's effectiveness as a feedback mechanism on remuneration practices. This is because shareholders, confronted with the possibility of forcing a board spill as a result of voting against a remuneration report

at a company where shareholders are generally satisfied with company performance and board oversight, may be unwilling to vote against. (sub. DD164, p. 3)

Given the desirability of having a clear and unambiguous signal from the non-binding vote, shareholders should not be inadvertently discouraged from voting. Consequently, were a two strikes mechanism to be introduced, there might be benefit from providing an 'opt out' option from an otherwise automatic trigger to require some or all directors to face re-election. For example, the ASX (sub. DD142) suggested that at the time that shareholders voted on the remuneration report (for a second-strike vote), they could be given the opportunity to indicate whether, in the event the second strike were triggered, they also wished to vote to re-elect directors.

Will shareholders pursue issues unrelated to remuneration?

It has been claimed that the potential for a board election arising from a 'two strikes' vote may allow minority shareholders to use the vote for reasons unrelated to remuneration — a 'trojan horse' argument. For example, the vote may be used indirectly to promote more serious strategic plays such as takeovers (and empower single issue groups). The Australian Institute of Company Directors (AICD) stated:

> The current system of non-binding votes on remuneration reports often sees shareholders use this as a way of expressing their discontent with the general performance of the company, the share price, strategic decisions by the board and so on. While there are other mechanisms shareholders could conceivably use … the non-binding vote on remuneration could be used as a 'cloak' for destabilising the board or company — for reasons unconnected to executive remuneration (e.g. environmental issues). (sub. DD149, p. 20)

The possibility of a 'trojan horse' scenario eventuating cannot be dismissed, but would be highly context specific, and such a strategy is likely to be difficult to disguise in practice.

Will directors 'walk away' from a second strike election?

According to the Business Council of Australia, forcing directors to stand for re-election over remuneration issues may result in them not submitting for re-election — with detrimental implications for board capacity and experience, succession planning and board performance:

> Where a board is spilled, the company may lose the experience, skills and the corporate knowledge of the directors that have been serving on the board. This is especially the case where board members who have been 'spilled' may be understandably disenfranchised and reluctant to stand for re-election. (sub. DD152, p. 8)

Many directors, being in the latter years of their business careers, are likely to undertake their directorships for non-pecuniary reasons, such as intellectual stimulation, 'relevance', and reputational and social benefits.

Companies left in limbo?

A concern expressed by some participants about the Commission's Discussion Draft proposal was that boards could end up being expelled 'en masse' leaving a void and, ultimately, company control in the hands of executives. For example, the Business Council of Australia stated:

> If the board were to be spilled, the executives upon whose remuneration the shareholders had voted would … in fact assume the responsibilities of the board until such time as a new board is elected. (sub. DD152, p. 8)

However, the prospect of this happening is remote. Any re-election would apply only to elected board members, not managing directors. All board members would have continued in their positions until the annual or extraordinary general meeting. At that meeting, elected directors would present *individually* for re-election. The record of director re-elections at meetings where substantial 'no' votes have been recorded on a remuneration report, establish that the likelihood of any directors achieving less than 50 per cent of votes cast would be extremely low, let alone all directors simultaneously. Were this extreme outcome to arise, various constitutional provisions relating to casual vacancies would be used to meet the legal requirement for companies to operate with at least three directors. While these outcomes may not be ideal, companies would not be left without boards.

Will remuneration practices become 'homogenised'?

While ramping up the consequences of a 'no' vote is designed to increase shareholder 'say' on pay to some degree, this needs to be balanced against maintaining the board's discretion to determine remuneration arrangements that promote the company's interests. As noted earlier, even the non-binding vote may have led to companies adopting pay structures that meet certain rules of thumb, but which may not be optimal for them ('vanillaisation'). Some participants considered that a 'two strikes' approach may unduly increase the influence of shareholder groups, large institutions and proxy advisers to promote their preferred pay structures. For example, Mercer submitted that a 'two strikes' approach:

> … will be instrumental in promoting a homogenised approach to the structure of executive remuneration. Such an institutionalised outcome may limit the extent to which boards feel free to design executive remuneration programmes to suit the specific needs of their respective enterprises. (sub. DD139, p. 10)

‘Vanillaisation’ of pay practices has also emerged as an issue in the United Kingdom, where shareholders have stronger powers in regard to approval of long-term incentives. Main et al. stated that remuneration arrangements have become homogeneous:

> Confronted with a desire to do the right thing and the need to be accountable for the outcome of their decisions, remuneration committees reach for the security of the institutional isomorphism and set in place remuneration arrangements that look very similar to those of their neighbours. (2007, p. 24)

It could be argued that it is up to boards to convince shareholders of the benefits of pay structures that differ from a form they prefer. However, if shareholders or representative organisations have immutable preferences, boards may be inclined to fall into line if the consequences of a negative vote outweigh the costs of implementing what they regard as sub-optimal pay structures. The risk of ‘vanillaisation’ of pay practices is credible and it underscores the need for good communication between boards and shareholders (especially institutional shareholders) and importantly, boards and proxy advisers (see section 9.4 for further discussion on the role of proxy advisers).

Can downside risks be moderated?

Participants have identified numerous downside risks associated with the ‘two strikes’ approach presented in the Discussion Draft. The prospect of some of these risks occurring, such as the ‘conflation effect’ and ‘vanillaisation’, will depend on the calibration of the ‘two strikes’ mechanism. In particular, separating the second strike from a decision to re-elect directors would directly address concerns about conflation.

With appropriate checks and balances in place, the Commission considers that the important benefits from a ‘two strikes’ approach can be attained cost-effectively. These benefits include added pressure on boards to better engage with, and be more responsive to, shareholder concerns about executive remuneration. Ultimately, shareholders should have a mechanism to sanction boards that prove unresponsive to such concerns, provided such a mechanism does not have adverse effects on boards that are responsive to the best interests of shareholders.

The critical design features of a ‘two strikes’ approach are explored further in developing the Commission’s recommendations in chapter 11.

9.4 Facilitating voting

In principle, the non-binding vote (and other areas of corporate voting) can hold boards accountable to their shareholders. However, the effect in practice will depend on the extent to which shareholders are considering and exercising their voting rights or otherwise engaging with the board, and whether there are any impediments to them doing so.

Are shareholders exercising their voting rights?

The voting turnout is one indicator of the level of shareholder engagement. Votes on the remuneration report will obviously have more impact, the greater the number of shareholders voting or otherwise engaging with the company.

Historically, the extent of voting in Australia has not been high by international standards, although there has been an increase in recent years. ACSI estimates that 'voting participation in the Australian jurisdiction is currently 55 per cent in the [ASX200], up from 35 per cent five years ago' (sub. 71, p. 13).

Information provided by ACSI also indicated that for the 2008 calendar year voting participation on ASX200 companies averaged:

- 54 per cent on remuneration report resolutions
- 57 per cent on director election/removal resolutions
- 57 per cent on increases in director fee pool resolutions (ACSI, pers. comm., 10 August 2009).

Egan Associates (sub. DD160) also provided data on the extent of voting in Australia, indicating that the median percentage of votes cast in a top 200 company was 54 per cent in 2008 (table 9.3). This has implications for what constitutes a majority vote, if there were a presumption that voting abstinence represented tacit endorsement.

It is sometimes observed that the voting rate in Australia is below that in the United States (which, according to Norges Bank (2006), averaged around 80 per cent in 2006). However, as ACSI noted, 'this is in an environment where voting is not compulsory for institutional investors unlike the US jurisdiction that obliges certain types of funds to exercise their proxy vote' (sub. 71, p. 13) (box 9.8).

Table 9.3 **Percentage of votes cast on company resolutions in the 2008 reporting season**

Companies	*75th Percentile*	*Median*	*25th Percentile*	*Average*
	%	%	%	%
Top 25	59	52	46	55
Top 50	65	58	48	57
Top 100	68	59	46	57
Top 200	66	54	43	54

Source: Egan Associates (sub. DD160).

While the extent of voting by shareholders is one indicator of engagement, institutional investors and advisory agencies may discuss issues with a company before the annual general meeting, including on issues related to the remuneration report (chapter 8). For example, in 2008, ACSI 'engaged' with 70 of the ASX200 companies (ACSI 2008a). In this way, investors may bring about changes to a company's remuneration practices without necessarily voting against the remuneration report. This was emphasised by the AICD:

> Institutional investors have a lot more influence than is generally recognised. We note, in particular, there has been a considerable increase in active engagement by large institutional investors on remuneration issues … This occurs through the exercise of voting rights, but increasingly also through direct engagement out of the public limelight with company board members … (sub. 59, p. 49)

The extent to which a shareholder will wish to be involved in corporate governance matters will depend on a number of factors, including the level and purpose of their investment, any statutory responsibilities associated with it, their interest in such matters and other priorities. Investors will weigh up the costs and benefits associated with monitoring, engaging and voting. For a small retail investor, the benefits associated with voting are likely to be small. Given the size of their investments, institutional investors are more likely to engage with a company and have the power to influence their remuneration practices. In total, institutional investors account for around one half of transactions on the ASX (ASX 2009d).

While the voting participation rate in Australia has increased, there may be principal–agent issues between funds and their investors, which may result in funds exercising their votes in ways that are not aligned with investors' interests (or not exercising them at all). To deal with this, some inquiry participants have suggested making voting by institutions compulsory, or requiring institutions to disclose their voting record.

Box 9.8 **Compulsory voting and voting disclosure — international approaches**

United States

Compulsory voting

The US Department of Labor interpretive bulletin 2509.94-2 effectively requires US pension funds to vote on company resolutions, where the resolution may have an impact on the fund's assets. The bulletin offers an interpretation of the Employee Retirement Income Security Act of 1974, which sets out the fiduciary duty of pension funds with respect to proxy voting. The interpretive bulletin states that:

> The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock. (US Department of Labor 1994, p. 1)

Further, the bulletin states:

> An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under [the Employee Retirement Income Security Act of 1974] where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved. (US Department of Labor 1994, p. 3)

Proxy voting disclosure

In 2003 the Securities and Exchange Commission (SEC) issued a new rule, requiring managed investment funds to disclose their proxy voting record. This rule requires the investment fund to file its voting record annually with the SEC. Further, the fund must make available to shareholders, either via their website or on request, their proxy voting record. The proxy voting disclosure must include:

- the name of the company
- the resolution voted on
- whether the resolution was proposed by management or the shareholders
- whether the fund voted on the resolution, and if so how it voted
- whether the fund voted for or against management recommendations (SEC 2003).

United Kingdom

Section 1277 of the Companies Act 2006 allows the Treasury to make regulations requiring institutional investors to disclose their voting records. This provision was introduced to allow the Government to make disclosure mandatory if there was not a significant increase in voluntary disclosure (LAPFF 2007).

Should institutional shareholders be required to vote?

It is claimed that the increased voting participation rate resulting from an obligation on institutions to vote would enhance the effectiveness of the voting system, with increased shareholder engagement and board accountability. A further argument is that institutional investors have a fiduciary duty to act in the best interests of their members, and that this requires them to take an active interest in corporate governance matters. Andrew Murray took this view and submitted:

> It would be ideal if institutions voted on all resolutions put before shareholders … At the very least, as a consequence of fiduciary responsibility, by law the voting record of institutions should be required to be made public. (sub. 28, pp. 8–9)

Further, since a large proportion of institutional investment derives from Australia's compulsory superannuation contribution system, it may be important that institutions investing these funds play a strong role in corporate governance matters (chapter 2).

Compulsory voting also has disadvantages. As noted earlier, institutional (and retail) investors make an assessment of the net benefits of considering and analysing the information required to make an informed vote. Where they choose not to vote, this may be an appropriate decision on their part, consistent with their voting policy, and a decision that minimises their costs and hence costs to their members. For example, the Investment and Financial Services Association (IFSA) has stated that compulsory voting 'may result in added costs for fund managers with little or no extra benefit to investors or company performance' (IFSA 2001, p. 14).

This view was supported by the CSA:

> A decision to abstain from voting on a matter, which may result in no proxy form being lodged and no attendance at a meeting, may be in accord with investor consideration or policy. Some institutional investors have decided not to vote on director elections, but to sell the stock if they do not agree with the board's decisions. (sub. 57, p. 28)

Consistent with institutional investors determining for themselves when it is in their best interests to vote, it is important to note that not all resolutions are equally important. Expending resources on routine voting matters may add unnecessary costs to institutions, paid for by their members, for little benefit. Hence, failure to vote cannot be taken as evidence of a lack of interest in company and corporate governance matters.

In addition, compulsory voting may lead to institutions ‘contracting out’ decision-making to consultants, or simply adopting a ‘tick-a-box’ approach to voting. Some have also questioned the value of compulsory voting in the United States:

> There is evidence that some external fund managers have created formalised procedures and voting guidelines that are basically window-dressing. (Stapledon 2001, p. 226)

Making voting compulsory also raises the need for enforcement, which could be problematic to implement in an effective or comprehensive way.

Disclosure of voting records

An alternative is to require institutional investors at least to *disclose* whether and how they voted. Potential investors would then be able to see how a fund has voted, and it would presumably be advantageous for a fund to be seen to be taking an active interest in corporate governance issues. However, unlike compulsory voting, institutional investors would not have to vote where they assessed there were no benefits in doing so.

Disclosure of voting records would also allow a company to see how institutions voted, promoting engagement on issues such as the remuneration report. The AICD noted that it can sometimes be difficult for boards to identify which shareholders voted against the board:

> Many listed companies have made genuine efforts to engage with shareholders, in particular institutional shareholders, on various issues including executive remuneration. However, this is not always a straightforward issue, particularly for larger companies. One of the problems boards have in engaging on issues such as executive remuneration with shareowners is often identifying those parties who decide how to vote on particular issues. (sub. DD149, p. 15)

The main disadvantage with disclosure of voting records would be the compliance burden placed on institutional investors. This could be reduced, however, by requiring the information to be disclosed electronically on websites only.

Some institutions (such as UniSuper) already provide detailed information about their voting record on their websites. In addition, IFSA (a not-for-profit organisation representing over 145 members, collectively responsible for investing over \$1 trillion) requires members to provide an annual summary of how they voted in the previous year. This must include the number of resolutions for which the institution voted, the number the institution voted for, against or abstained from, and the number of resolutions where the institution took no action. This summary is generally placed on the website of the institution.

However, some participants argued against disclosure of voting records. The Business Council of Australia suggested that such disclosure may inhibit, rather than encourage voting:

> It is possible that such a disclosure requirement will inhibit rather than encourage institutional holders from voting or voting against board-supported resolutions. Institutional investors may wish to avoid public conflict or the need to articulate reasons publicly from voting at all or from voting against board-supported resolutions. (sub. DD152, p. 12)

The CSA suggested that disclosure of voting records would force institutions to vote according to the 'popular line':

> The political pressure to vote according to a popular line could potentially overshadow the benefits being achieved through ongoing dialogue between the institutional investor and the board. Compelling the disclosure of a vote can introduce distortions in voting outcomes. (sub. DD147, p. 9)

However, institutions have a fiduciary duty to act in the best interest of their members. As such, it is unlikely that disclosure of voting would inhibit voting against resolutions. Further, institutions that currently disclose their voting records, such as UniSuper and VicSuper, vote on the majority of resolutions, and often vote against board recommendations. (In its submission, UniSuper stated that it has voted against 15 per cent of remuneration reports (sub. DD118, p. 1).)

An additional issue is which institutions should disclose their voting records. Institutional investors include superannuation funds, life insurance companies and mutual funds (chapter 2). As noted earlier, in light of Australia's compulsory superannuation system, participation in corporate governance matters by superannuation funds in desirable, and disclosure of voting records may assist this. However, for smaller institutional investors, disclosure of voting records may impose a large compliance burden, for little real benefit.

Securities lending

A further complication is the practice of securities lending by institutions, which involves an institution lending shares (usually to another institution), while retaining all economic rights to the shares, including dividend payments. However, as the title of the share is transferred, the voting rights associated with the shares are transferred to the borrower. This can result in votes being cast on resolutions by those with no economic interest in the company, or shares being borrowed for the sole purpose of influencing a resolution. According to RiskMetrics:

> This decoupling of voting rights from an economic interest in the company carries the potential for shares to be borrowed for the principal purpose of casting the votes attaching to the shares. This can distort the results of shareholder voting, particularly in relation to controversial matters or other matters on which shareholder views are finely balanced. The voting result in that situation may not necessarily reflect the interests of the majority of shareholders that hold both title to and the economic incidents of shares. (sub. 58, p. 15)

Whether an institution should also disclose information on the number of shares loaned out is another issue. In this regard, the Commission notes that the Reserve Bank of Australia and the ASX are considering making security lending more transparent, including by disclosing daily the aggregate number of loan transactions for each security on the ASX (RBA 2009). Further, IFSA recommends that its members discuss policies relating to securities lending arrangements, and ensure that all lending activity is lawful and voting entitlements exercised appropriately.

Both IFSA (sub. DD144) and Guerdon Associates (sub. DD119) argued that stock lending has positive effects, such as contributing to market liquidity. Further, ACSI (sub. DD156) suggested that funds that lend stock generally provide for recall of the stock if voting is required. IFSA noted that the incidence of securities lending for voting purposes in Australia is relatively rare (IFSA 2009). As such, the concerns regarding the impact of securities lending on voting do not appear to be widespread. However, it is important that disclosing voting records does not inadvertently inhibit securities lending.

Avoiding 'lost votes'

In order to facilitate shareholder engagement, it is important that an effective system of voting exists whereby shareholders can vote despite not being able to attend a general meeting. In the absence of a direct voting system, proxy voting allows shareholders to appoint a person to vote on their behalf.

It is obviously important in assessing the views of shareholders that the proxy voting system can correctly process shareholder votes. An emerging issue with proxy voting is the phenomenon of 'lost votes', where proxy votes from shareholders are incorrectly processed, or not processed at all. For example, AMP Capital Investors (2009) found that in the main proxy season of 2005, at least 4 per cent of their voting instructions had been lost.

Submissions suggested that this may be a consequence of the current paper-based system of proxy voting. Paper-based voting has potential for processing errors, and does not offer a full audit trail (investors receive no confirmation as to whether their votes have been accepted). In addition, the cut-off date for determining a shareholder's voting entitlements can result in shareholders submitting more votes than they are entitled to, resulting in all their votes being rejected (box 9.9).

Paper-based proxy voting

The issues surrounding paper-based voting are of long standing. They have been considered recently by the Parliamentary Joint Committee on Corporations and Financial Services. The Committee concluded that:

> … the integrity of the proxy voting system could be improved if more companies established an electronic proxy voting capability that provides a clear audit trail … processing votes via a paper-based system is outdated and prone to error. (2008, p. 46)

An electronic voting system would clearly alleviate some of the issues associated with the antiquated paper-based system. Electronic voting could still be a proxy-based system, but would enable both the appointment of a proxy and subsequent voting to occur over the internet. The Corporations Regulations allow for the appointment of a proxy to be made electronically. However, the Parliamentary Joint Committee on Corporations and Financial Services (2008) and IFSA (2007) suggested that, since the Corporations Act does not explicitly require a company to offer electronic voting, there may be some uncertainty as to whether a company is permitted to use electronic voting where this is not provided for in its constitution. The Australian Securities and Investments Commission, however, suggested that electronic voting was legal without constitutional amendments:

> ASIC believes that the [electronic] appointment and authorisation of proxies is permitted currently by the *Corporations Act 2001* and in most cases can be implemented without a company needing to change its constitution. (sub. DD162, p. 2)

Internationally, particularly in the United States and in the United Kingdom, the use of electronic voting is more widespread (box 9.10). All FTSE 100 companies in the United Kingdom offered electronic proxy voting in 2006. In contrast, Computershare reported that the number of Australian votes received electronically in the 2008 proxy season was 10 per cent of votes cast (Computershare 2009). However, there is some evidence that the take-up of electronic voting is increasing. The Australasian Investor Relations Association noted: '… certainly in the meeting season that has just been in May, I noticed a significant increase in the number of proxy forms that provided for electronic lodgement' (trans., p. 105).

Box 9.9 **Causes of 'lost votes' — views from submissions**

The CSA commented on the current paper-based system:

> We are aware of the issue and we believe it is true that in some cases proxy votes have gone missing … We think the problem needs to be solved, that it's probably a cumbersome process which is largely a paper-based process, and in this day and age we should probably be moving beyond that. (trans., p. 123)

It also stated that:

> IFSA set up a Roundtable … to investigate lost votes. The stakeholder group identified the manual processing of paper-based instructions, the lack of audit trail and time pressure (caused by a coincidence of dates for proxy form lodgement and the determination of vote entitlement) as key weaknesses in the current system. (sub. DD147, p. 10)

Similarly, RiskMetrics stated:

> … a bigger problem is missing votes or a complete lack of an audit trail … with dozens of instances where votes have simply gone missing … (trans., pp. 366–7)

The Law Council of Australia advocated electronic direct voting to prevent lost votes:

> The Committee believes that the introduction of electronic direct voting would overcome many of the issues which arise in relation to proxy voting … and many of the issues associated with a paper based system … (sub. DD150, p. 5)

A further issue raised by RiskMetrics is the cut-off date for the company's determination of voting entitlements (record cut-off date):

> Under the present proxy voting arrangements in Australia, there are two cut-off dates … (a) proxy appointments must be received by a company at least 48 hours before a meeting; and (b) the company's determination of voting entitlements for a meeting must be based on the persons who were shareholders not more than 48 hours before the meeting.
>
> The coincidence of these two cut-off dates creates the potential for discrepancies between the votes lodged via proxies and the votes held at the second of these cut-off dates. (sub. 58, p. 14)

The Australasian Investor Relations Association recommended that:

> … the record cut-off date be increased to five business days prior to the shareholder meeting … (trans., p. 104)

By removing most of the manual elements in proxy voting, problems such as illegible proxy forms and human processing errors, would be eliminated. An electronic proxy voting system would also facilitate the introduction of a proper audit trail. This would enable investors to confirm that their votes had been processed according to their instructions, and provide reassurance about the accuracy of voting outcomes on contentious issues.

Box 9.10 **Electronic voting — approaches overseas**

United Kingdom — UK law was amended in 2000 to allow electronic voting. In 2006, the proportion of FTSE 100 shares that were voted electronically was 45 per cent, with the proportion voted by paper 11 per cent. In addition, all general meetings of FTSE 100 companies, and 74 per cent of meetings in FTSE 250 companies, allowed for electronic voting (Myners 2007). The UK system allows for a shareholder to receive information electronically, cast their proxy online, and offers a clear audit trail.

United States — most US states allow for proxy votes to be made electronically, with Delaware going as far as to allow the exclusive use of a virtual shareholder meeting. According to Broadridge, a leading US share registry, 91 per cent of votes through Broadridge in 2009 were voted electronically (Broadridge 2009).

In 2007, the **European Union** issued a directive to their members on shareholder voting, stating that:

> Companies should face no legal obstacles in offering to their shareholders any means of electronic participation in the general meeting. Voting without attending the general meeting in person, whether by correspondence or by electronic means, should not be subject to constraints other than those necessary for the verification of identity and the security of electronic communications. (2007, p. 5)

In relation to electronic voting, the **OECD's** principles of corporate governance state:

> The objective of facilitating shareholder participation suggests that companies consider favourably the enlarged use of information technology in voting, including secure electronic voting in absentia. (2004, p. 35)

Some participants raised concerns that, were electronic voting widely implemented, it would completely replace the paper-based system of voting (Macquarie Group, sub. DD157; Colin and Anna MacKenzie, sub. DD117). The Commission does not envisage this would be the case, and notes that the Corporations Act requires a company to specify a place and a fax number for the receipt of (paper-based) proxy appointments (s. 250BA).

Electronic voting could facilitate direct voting, bypassing the need for a proxy, and thus avoiding many of the flaws associated with a proxy voting system. According to the CSA (2007), direct voting does not require legislative change, and can be provided for in the company's constitution (by a special resolution of members).

The Parliamentary Joint Committee on Corporations and Financial Services noted that in 2008, direct voting was permitted in 13 per cent of the ASX200 companies' constitutions. On the issue of direct voting, the Committee stated:

> Widespread implementation of direct voting would overcome many of the problems associated with proxy voting as identified during the inquiry. Companies should be encouraged to amend their constitutions to provide for direct absentee voting, which could be assisted by the ASX Corporate Governance Council including an 'if not, why

not' provision on direct voting in its Corporate Governance Principles and Recommendations. (2008, p. 52)

While there have been no estimates of the cost of implementing electronic voting (for proxy or direct voting), the Parliamentary Joint Committee considered that it would not be prohibitive. Moreover, once established, the ongoing cost to the company of processing a vote electronically would be significantly less than paying for the mailing and processing of a paper-based vote. For the United States, Broadridge reported that in the 2009 proxy season, cost savings arising from paper reduction and postage savings from use of their ProxyEdge electronic voting platform amounted to US$42 million (Broadridge 2009).

Record cut-off date

There are two cut-off dates that are of relevance for proxy voting: one for confirming shareholder voting entitlements (record cut-off date), and one for submitting proxy votes.

- The record cut-off date is 48 hours or less before the general meeting. This is as close to the meeting as possible to ensure that an accurate picture of the shareholder group at the time of the meeting is captured.
- The deadline for submitting proxy votes is 48 hours or more before the meeting. This is to provide the company sufficient time to process the proxy votes prior to the meeting.

The difference in timing of these two cut-off dates may give rise to lost votes. The cut-off dates can result in shareholders submitting their proxy prior to their voting entitlements being determined, leading to a discrepancy between voting entitlements and the number of votes cast. If the number of proxy votes submitted exceeds the number of votes a shareholder is entitled to, this can result in all votes from the shareholder being rejected. In addition, the dates may result in many votes being submitted at the last minute, leaving little time to resolve any queries.

IFSA suggested the record cut-off date should be extended to five days before the general meeting. This was also recommended by the Australasian Investor Relations Association (box 9.9). Treasury indicated that this 'may be a very valuable reform, but that it had not been raised with Treasury directly' (Parliamentary Joint Committee on Corporations and Financial Services 2008, p. 46).

Extending the record cut-off date would provide an increased buffer between the establishment of voting entitlements and submitting votes. This would decrease the risk that shareholders (especially institutional investors) lodge more votes than they are entitled to. Further, as it would allow institutions to vote earlier, there may be more time to resolve any potential discrepancies.

There are some disadvantages associated with extending the record cut-off date. Such a change would increase the risk that votes may be cast by shareholders who no longer have a substantive interest in the company. That is, shareholders may sell their shares before the meeting (but after the record cut-off date). Similarly, shareholders may buy shares after the record cut-off date and therefore not be able to vote at the meeting. These issues are amplified the further out from the meeting the record cut-off date is set.

It should be noted that the need for a record cut-off date is reduced with the introduction of electronic voting. The US state of Delaware (where most US companies are registered) has recently changed its regulations to move the cut-off date closer to the general meeting. The new regulations allow for the board to set a record cut-off date, differing from the date the notice of meeting is sent. There is no limit on how late this date can be set — potentially it could be set on the day of the meeting (Hanley 2009).

Consequently, encouraging electronic voting may be a better option as it would also reduce the risk of a discrepancy between voting entitlements as determined at the record cut-off date compared to entitlements at the time of the meeting. In the absence of the widespread take-up of electronic voting, extending the record cut-off date becomes more important as a means of reducing lost votes. Options are explored further in chapter 11.

The role of proxy advisers

Prior to exercising their vote, shareholders may seek advice from proxy advisers. Businesses such as RiskMetrics and CGI Glass Lewis — which dominate this market segment — undertake research on companies and offer advice to their subscribers on how to direct their proxy vote. This can be an important service for institutional investors who have invested in a large number of companies, as well as for smaller investors who may lack the time or resources to carry out such research themselves. Some submissions have raised concerns that proxy advisers may have become too influential in deciding the outcomes of company resolutions (box 9.11). These issues relate to:

- institutional investors simply following the recommendations of proxy advisers without question (for example, some institutions may have insufficient resources domiciled in Australia to analyse the advice)

- proxy advisers lacking the time and resources, particularly during the company reporting season, to engage with companies about areas of concern, and/or adopting inflexible positions on remuneration issues that may not be appropriate for all companies
- the incentive for proxy advisers to find fault with company governance arrangements in order to generate business.

It remains the case, however, that institutional investors have a fiduciary duty requiring them to vote in the best interest of their clients. In addition, while proxy advisers may have incentives to highlight poor corporate governance practice, they will need to be able to back up their recommendations, or risk losing credibility and clients. RiskMetrics further observed that proxy advisers operate in a free market, and that if they did not offer useful advice, companies would not use them:

> … there's no compulsion to buy our service, there is no compulsion at all to follow our advice and frankly, it's ridiculous to suggest that in some way, our very sophisticated clients would donkey vote off the back of our recommendations. It is true though that we have influence and we have influence only insofar as we can back up what our recommendations are. … If we weren't providing value, our clients would not employ us. (trans., pp. 360–1)

A further concern raised is that some proxy advisers do not engage with a company prior to recommending a 'no' vote. For example, the AICD stated:

> We went to the AGM a couple of weeks ago … we consulted with all of the people through that process and we were not aware of anything until a few days before a [proxy adviser] that we had not engaged with came out with a report, clearly no consultation with the company, and had recommended to their clients to vote against it … We engaged with them and clearly there had been a misunderstanding in terms of their understanding of what is a relatively novel awards system. (DD trans., p. 130)

While it is unclear how widespread such practices are, *the Commission sees obvious merit in proxy advisers engaging with companies prior to recommending a 'no' vote*. Ensuring that proxy advisers fully understand the rationale behind any 'novel' elements of a company's remuneration arrangements can only lead to more informed recommendations. Further, early engagement between companies and proxy advisers could potentially lead companies to improve, or better explain, their remuneration outcomes.

In light of the influence of proxy advisers, there are some who have contended that they should be prevented from making recommendations on resolutions. However, since investors are not obliged to follow the guidance of proxy advisers, even if some have that as their default position, such a proposal seems excessive and could perversely result in a reduction in the availability of relevant market information.

Box 9.11 **The power of proxy advisers — views from submissions**

The CSA raised the following concerns:

> … proxy advisory services do wield influence and that influence should not be underestimated. The recommendations put forward by proxy advisory services will be attended to by those who commissioned the research. In some instances, investors may not exercise their discretion or may be reluctant to vote against the recommendations of proxy advisory services. (sub. 57, p. 28)

Similarly, Charles Macek stated:

> In my capacity as the Chairman of a Board Remuneration Committee I have received verbal and even written confirmation by some investors that they follow or, in some cases, are required to follow the recommendations of a specific proxy adviser. (sub. 55, p. 9)

The AICD also noted the influence of proxy advisers, and suggested it may be in their interests to find fault with companies:

> … proxy advisers who advise clients on how to vote remuneration and other corporate governance issues can be influential regarding voting outcomes, yet they typically have no … 'skin in the game'. Such advisers face a potential moral hazard, insofar as it could be said to be in their commercial interests to be highlighting their worth by finding fault with company governance arrangements. (sub. 59, p. 49)

Along similar lines, Charles Macek suggested:

> There is also an inherent conflict between providing objective research that shareholders can use in considering how to vote and advocacy. This is reinforced by a moral hazard which is created by the desire to demonstrate value from a low margin service i.e. proxy advice. This can be done by emphasising 'bad' practice and exaggerating its prevalence, rather than highlighting good practice. (sub. 55, p. 8)

KPMG suggested that proxy advisers adopt a tick-a-box approach, that may not be appropriate for every company:

> … remuneration practices that meet the 'tick-a-box' requirements of corporate governance and proxy advisers … may not be effective for the particular business or executive and will not necessarily be the most appropriate policies to create shareholder value. (sub. DD145, p. 7)

CGI Glass Lewis and Guerdon Associates suggested that institutional investors do not blindly follow the advice of proxy advisers:

> In practice, however, institutional clients of the proxy advisers use the analysis and voting recommendations of one or both proxy firms as part of their input into reaching their own final voting decision. This is borne out from CGI Glass Lewis's experience and review of actual voting results … (sub. 80, p. 42)

9.5 Reducing conflicts of interest

It is important for the integrity of the voting system that conflicts of interest do not occur. In regard to the non-binding remuneration report vote, conflicts of interest may mute the shareholder 'signal', and limit the usefulness of the vote. Conflicts of interest in the voting system can arise where a person who may gain a material personal benefit from a resolution can influence the result of the resolution, either by voting their own shares or acting as a proxy holder.

Should directors and executives vote on the remuneration report?

All shareholders in a company are able to vote on that company's remuneration report, including those who are named in the report — that is, directors and executives whose remuneration is being voted on. This conflict of interest was raised in numerous submissions (box 9.12).

While the influence on the outcome of directors and executives voting is likely to be negligible in most cases, in some instances the shareholdings of a director or executive are significant and potentially influential. Stephen Mayne noted the significant share holdings of Frank Lowy (170 million shares or 10 per cent of Westfield) and Paul Little (10 per cent of Toll Holdings) (trans., p. 238).

Precluding those named in the remuneration report from voting on it would address the potential conflict and give investors some confidence that the vote on the remuneration report accurately reflects their support for it. However, some have argued that the prohibition on voting needs to apply only to key management personnel, and not non-executive directors, because the director fee pool is already set by shareholders and directors are under a fiduciary duty to act in the best interests of the company.

While it is true that non-executive directors have a fiduciary duty, the non-binding vote on the remuneration report represents one of the few areas where shareholders have an 'automatic' (in the sense that there is an annual vote on the report) and relatively direct avenue for voicing their concerns (short of selling their shares). It is therefore important that this avenue is able to capture clearly the views of 'outside' shareholders. It can also be argued that the non-binding nature of the vote on the remuneration report makes it a special case, which minimises concerns about excluding directors from voting on other resolutions they have a role in proposing.

This issue is further discussed and recommendations presented in chapter 11.

Box 9.12 **Remuneration report conflicts — views from submissions**

The CSA and RiskMetrics both raised concerns with those named in the remuneration report also voting on the report:

> There is a conflict of interest in directors and CEOs voting on their own remuneration policies. CSA believes that this disempowers shareholders. (CSA, sub. 57, p. 26)
>
> The primary role of the non-binding remuneration report is to allow shareholders to convey their view of a company's remuneration practices to the board. As such, it appears counterproductive to allow members of key management personnel to be able to vote on this resolution … (RiskMetrics, sub. 58, p. 8)

Macquarie Group felt that excluding executives would have little impact on the vote:

> The resolution is not binding and for most large corporations the number of votes held by such executives would be small and unlikely to influence the outcome. This would be an issue where a dominant shareholder took excessive remuneration. (sub. 52, section 2, p. 8)

BHP Billiton and the AICD agreed:

> In the majority of companies where shares are widely held by investors, there would not be a material impact in restricting the ability of Directors to vote … (BHP Billiton, sub. 45, p. 8)
>
> On balance, we see little marginal benefit, if any, in prohibiting voting by those individuals named in the remuneration reports … (AICD, sub. 59, p. 48)

Other submissions drew a distinction between directors and executives voting on the remuneration report. For instance, Origin noted:

> Since non-executive directors have their aggregate remuneration or fees approved directly by shareholders, and recommend the Remuneration Report, there is no logical basis on which non-executive directors should be prohibited from voting their own shares. (Origin, sub. DD129, p. 2)

Similarly, for a range of reasons Guerdon Associates did not think directors should be excluded from voting, including:

> a. The Corporations Act does not allow directors and related parties to exercise votes on resolutions where they have a pecuniary conflict of interest
>
> b. Directors have a legally binding fiduciary obligation … (Guerdon Associates, sub. DD119, p. 4)

While the ASX supported the prohibition on key management personnel voting their shares 'where there is a direct conflict of interest' (sub. DD142, p. 5), it added:

> … ASX is not supportive of the wide scope of the proposed prohibition … such that directors (and their associates) are excluded … where they will not directly obtain a benefit from the outcome of the resolution … ASX notes that where there is a direct conflict … directors are excluded from voting their shares under the Listing Rules … (sub. DD142, p. 5)

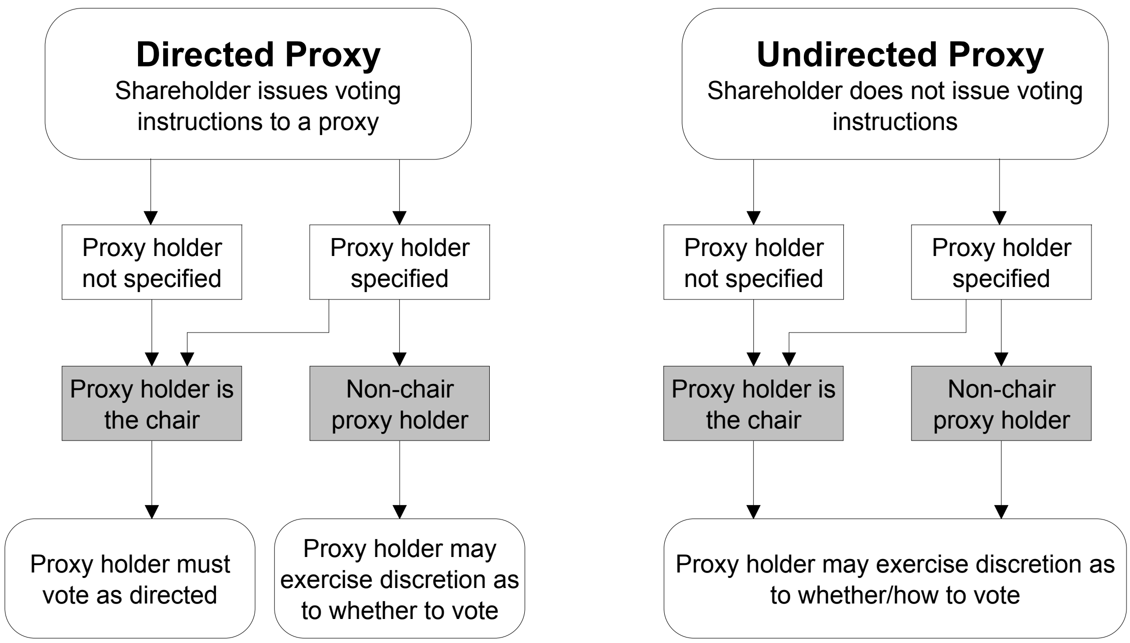
Proxy voting

Regardless of whether a director or executive is banned from voting their own shares on a resolution, they may still be able to affect the resolution's result through the proxy voting system. Under part 2G.2 of the Corporations Act, a shareholder can provide either 'directed' or 'undirected' proxies to their proxy holder.

- With directed proxies, shareholders make known their voting instructions to the proxy holder. The chair of the meeting must vote all their directed proxies, however non-chair proxy holders are under no obligation do so.
- Where voting instructions are not specified, this is an 'undirected' proxy, which allows the proxy holder to choose which way to vote.

Figure 9.1 illustrates the proxy voting framework under both directed and undirected proxies. Particular issues in the proxy voting system arise in relation to undirected proxies to the chair and the potential for 'cherry picking' of votes by non-chair proxy holders.

Figure 9.1 **Proxy voting framework**



Undirected proxies to the chair

Under current arrangements, if a proxy is 'undirected', the proxy holder has discretion to determine how to vote the proxies. Generally, if the shareholder does not appoint a proxy, the proxy defaults to the chair. Under ASX listing rule 14.2.3, if the chair is excluded from voting his or her own shares, the proxy form must contain:

- a statement as to how the chair intends to vote undirected proxies

- a notice stating that the chair may have a conflict of interest in a resolution. Shareholders must mark a box noting that they understand this statement. If the box is not marked the undirected proxies must be disregarded; otherwise chairs may exercise undirected proxies at their discretion.

Notwithstanding these statements, chairs may be conferred with voting powers in areas where they would otherwise be formally excluded from voting their own shares.

Directors exercising undirected proxies on resolutions where they are otherwise prohibited from voting represents a potential conflict of interest, which regulation has seen fit to remove in regard to the director's own shares. Under current legislation, there is potential for such a resolution to be approved due to the exercise of undirected proxies by those receiving a material benefit from the resolution. An option for reform is to disallow the chair from voting undirected proxies in such circumstances. This could be important with respect to the non-binding remuneration report vote — the primary purpose of which is to signal to the board shareholder views on remuneration. The chair exercising undirected proxies may mute this signal, particularly where undirected proxies are large enough to influence the outcome of a vote.

The Commission examined the results of remuneration report resolutions in ASX100 companies in 2008 (table 9.4). Undirected proxies accounted for 1.8 per cent of total proxy votes received in the median ASX100 company (it should be noted that this figure takes into account undirected proxies received by any shareholder, not just directors). This figure rose to 3.3 per cent for the median ASX20 company. In some atypical cases, undirected proxies accounted for over 10 per cent of proxy votes.

Some organisations have argued against excluding undirected proxies, on the basis that such a reform may disenfranchise retail shareholders:

> Origin's concern with [excluding undirected proxies] is that its primary effect is to disenfranchise retail shareholders. It is a legitimate choice for shareholders to express confidence in and support for their board by giving their undirected proxies to the Chair or another person, including a member of management or a director. (Origin, sub. DD129, p. 2)
>
> Shareholders currently provide undirected proxies to individuals that they trust. Inability to exercise would nullify and disenfranchise these investors' votes. (Guerdon Associates, sub. DD119, p. 4)

Table 9.4 **Proportion of undirected proxies to total proxies received[a] on remuneration report resolutions, 2008[b, c]**

Company group	*Average*	*Median*
	%	%
ASX20	3.3	3.3
ASX50 (excluding ASX20 companies)	2.6	2.0
ASX100 (excluding ASX50 companies)	3.9	1.4
ASX100 (all companies)	3.3	1.8
All ordinaries[d] (excluding ASX100 companies)	5.0	1.4

[a] Excluding proxies with a direction for the proxy holder to abstain. [b] Note that the figures represent undirected proxies given to all proxy holders as a proportion of total proxies. Undirected proxies received by *directors* as a proportion of total *votes* cast will be a lower figure. However, Commission estimates suggest that proxy votes often account for around 99% of total votes cast on a resolution. [c] Some ASX100 entities (such as trusts and overseas companies) did not have a remuneration report resolution in their 2008 general meeting, and have been excluded from the sample. The sample includes 82 ASX100 companies. [d] A sample of 20 randomly selected all ordinaries companies.

Sources: Company announcements; Productivity Commission estimates.

A further argument against excluding undirected proxies is that the chair has a fiduciary duty to the company, and must exercise the proxies in accordance with this fiduciary duty:

> Shareholders who intentionally make the choice to leave their proxies open for the chairman or other non-executive directors of the board to vote are quite likely to be signalling that they trust the chairman/directors to act, in accordance with their fiduciary responsibility, in the interest of the company. (ASX, sub. DD142, p. 6)

It could be argued that shareholders should have the choice to give an undirected proxy to the chair, and that disregarding undirected proxies may also not give a true indication of shareholder opinion — shareholders may wish to simply follow board views on resolutions. However, shareholders would still have the option of following board recommendations. Boards generally state on the proxy form their voting recommendations, and in the case of the remuneration report, the board's position on the resolution is clear. A shareholder simply needs to issue a directed proxy that follows the board's recommendations — that is, vote for the remuneration report.

However, requiring shareholders to issue directed proxies may result in shareholders' votes being ignored, despite them wishing to support the board. The CSA estimated that, when listing rule 14.2.3 was introduced in 2001, 20 per cent of shareholders issuing undirected proxies did not understand the rule change, and so had their votes disregarded despite wishing to voice support for the board (DD trans., p. 105).

While the board often indicates which direction they intend to vote their undirected proxies, RiskMetrics suggested that requiring shareholders to give a directed proxy may be preferred as there is some uncertainty as to whether chairs are legally bound to follow these voting intentions:

> … it's not just a matter of undirected proxies that can be voted by the chairman in favour of these things but the very fact that a chairman, according to the Jervois Mining decision earlier this year, can change their mind on the floor of the meeting and be subject to no fiduciary duty to vote in accordance with what they had declared prior to the meeting. (trans., p. 366)

However, the Law Council of Australia (sub. DD150) suggested that this uncertainty should not be overplayed. In the Jervois Mining case the proxy form contained voting intentions that were contradictory to those on the notice of meeting. Normally, 'a chair is likely to be precluded from voting contrary to the intention statement by laws relating to misleading or deceptive conduct' (Law Council of Australia, sub. DD150, p. 3).

It should also be noted that excluding undirected proxies would result in Australia's treatment differing from other countries. Undirected proxies in the United Kingdom and the United States are handled in a similar way to the current Australian system (box 9.13).

In light of the potential disenfranchisement of retail shareholders, the Commission considers that listing rule 14.2.3 is appropriate in most circumstances. However, there are strong arguments to disallow the chair from voting undirected proxies in the special case of the remuneration report. Here, the purpose of the vote is to send a (non-binding) signal to the board on 'outside' shareholder views of remuneration policy. As such, influence by the board on the result of the vote should be minimised. The use of undirected proxies by the chair may mute the shareholder signal, diminishing the usefulness of the non-binding vote.

These issues are considered further and recommendations presented in chapter 11.

'Cherry picking'

Under current regulations non-chair proxy holders are not required to exercise all their directed proxy votes when they vote their own shares, allowing for 'cherry picking'. This can arise where proxy holders hold directed proxies with voting instructions opposite to their own voting intention (that is, to how they will vote their own shares). Proxy holders may exercise their own votes and proxy votes that support their view, and ignore other proxy votes. Note that the chair is obligated to exercise all directed proxies.

Box 9.13 **Conflicts of interest — approaches overseas**

United States — regulation of proxy voting in the United States is similar to Australia. Securities and Exchange Commission rule 14a-4 sets out the requirements of the proxy. In particular, the rule states that the chair may vote undirected proxies at its discretion, on the provision that the proxy form states clearly how the board intends to vote undirected proxies.

United Kingdom — in relation to undirected proxies, the UK listing rules state that the proxy form must notify the shareholder that if the form is returned without voting instructions, the proxy may exercise their discretion as to how to vote.

Canada — Canadian federal corporations law requires a person who solicits a proxy, and is appointed as a proxy holder to attend the general meeting and comply with the shareholder's instructions. Where management solicits proxies, a circular must be attached to the proxy form, outlining any material interests in a resolution of each director and senior executive of the company.

In 2007 the **European Union** issued a directive on shareholder voting, stating:

> The proxy holder should therefore be bound to observe any instructions he may have received from the shareholder and Member States should be able to introduce appropriate measures ensuring that the proxy holder does not pursue any interest other than that of the shareholder, irrespective of the reason that has given rise to the conflict of interests. (2007, p. 6)

The **OECD's** principles for corporate governance state:

> … it is important to the promotion and protection of shareholder rights that investors can place reliance on directed proxy voting. The corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder … (2004, p. 35)

The 'cherry picking' problem has been considered previously by the Australian Treasury. A proposed amendment (Corporations Amendment Bill (No. 2) 2006) to the Corporations Act contained reforms to prevent 'cherry picking'. In relation to 'cherry picking', the proposed amendment stated:

> If the proxy is not the chair — the proxy need not vote on a poll, but if the proxy votes on the poll in any capacity, the proxy must vote on the poll in the exercise of the proxy appointment and must vote in the way specified in the proxy appointment. (Corporations Amendment Bill (No. 2) 2006, p. 4)

Under the reform, non-chair proxy holders would be under no obligation to cast their proxies, but if they did cast a vote, they would be required to cast all their proxies. However, other proposed amendments under the bill (such as the abolition of the '100 member rule' for calling extraordinary general meetings) were not supported by the states, and as such, this bill has not yet been put to Parliament.

The Parliamentary Joint Committee on Corporations and Financial Services considered the same issue and recommended: 'The government should amend the

Corporations Act to prevent non-chair proxy holders from cherry picking votes' (2008, p. 48).

The proposal, as outlined in the Corporations Amendment Bill (No. 2) 2006, would end the practice of 'cherry picking', thereby increasing the transparency and effectiveness of shareholder voting — the vote would more clearly reflect the view of all shareholders who returned their proxy forms.

However, the proposed reform would not entirely remove the conflict of interest for non-chair proxy holders. If proxy holders receive a large amount of proxies that do not support their views on a resolution, they would have the option of simply not voting *any* proxies. To counter this, a further reform option may be to require non-chair proxy holders to vote all their directed proxies, regardless of whether they vote their own shares in a poll.

The explanatory memorandum to the Corporations Amendment Bill (No. 2) 2006 suggests that this may be too onerous a requirement, stating that a proxy holder may be unknowingly appointed and there may be legitimate reasons why they are unable to attend a meeting or vote on a poll. However, the proposed amendment also states that the requirements on non-chair proxy holders would only apply when:

> (i) the person agreed to act, or held himself or herself out as being willing to act, as proxy at the meeting and was aware of his or her appointment as proxy; or
>
> (ii) the company held the person out, with the person's consent, as being willing to act as proxy at the meeting and the person was aware of his or her appointment as proxy. (Corporations Amendment Bill (No. 2) 2006, p. 5)

Thus the legislation would only apply where the proxy has consented to, and is aware of, their appointment. It should also be noted that where a non-chair proxy holder does not attend the meeting, the proxy generally defaults to the chair of the meeting (who is currently required to exercise the directed proxies). As such, there may be scope to require proxy holders to vote all their directed proxies, regardless of whether they vote their own shares. However, it is important to consider that there may still be circumstances where a non-chair proxy holder is unable to vote on a poll (for example, if they need to leave the general meeting early) and it is important that a non-chair proxy holder not be penalised where they are unable to vote their proxies for legitimate reasons. These issues are considered further in chapter 11.

10 Taxation issues

Key points

- The Australian tax system does not specifically target executive remuneration quantum or structure. In other jurisdictions, additional taxes have been imposed on components of executive remuneration, or access to concessions disallowed.
- Using the tax system to constrain particular components of executive remuneration can have perverse consequences, including:
  - consequential increases in other components of executive remuneration. This in turn can impact on the extent that remuneration is linked to performance and may also serve to increase total remuneration
  - the use of tax ‘gross-ups’ which may increase total remuneration and raise costs to the company.
- Equity-based payments are an increasingly significant component of executive remuneration. Taxation of equity-based payments can be complex, as:
  - different amounts may be variously taxed as salary or substitutes for salary, fringe benefits, or capital gains
  - there are several points in time at which tax can apply
  - the value of future, or contingent, equity rights can be very difficult to determine.
- The timing of the taxation of equity-based payments and the value placed on equity can have a significant influence on the total amount of tax paid.
- Currently, income tax on equity-based payments is generally payable at termination of employment, irrespective of whether performance conditions or holding requirements still apply.
  - 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.

10.1 Introduction

Taxation arrangements have the potential to influence the level and structure of executive remuneration, including the extent of alignment between executive and shareholder interests. Many participants suggested that tax policy does indeed affect remuneration design in Australia. However, to date, Australian tax law has not been used actively to influence remuneration levels and design — unlike some other countries, where employer tax deductions have been limited or additional taxes imposed on components of executive remuneration.

The government has appointed a panel to review Australia's Future Tax System, chaired by Dr Ken Henry (box 10.1). Taxation arrangements for executive remuneration clearly fall within that review's scope. However, given the breadth of the review's terms of reference and its longer-term focus — together with the existence of this inquiry — it is unlikely that executive remuneration will be a significant part of the review.

There have been other such reviews of relevant taxation issues, particularly relating to equity received through employee share schemes (box 10.2).

In this inquiry, the Commission has been asked by the Government to consider the role played by tax treatment of equity-based remuneration in better aligning the interests of boards and executives with shareholders and the wider community.

This chapter examines the extent to which current taxation arrangements influence executive remuneration levels and structure. It includes a consideration of equity-based payments (such as those provided through employee share schemes) including recent modifications, in addition to taxation arrangements for executive

Box 10.1 **Review of Australia's Future Tax System**

This review encompasses Commonwealth and State taxes (except, notably, the goods and services tax) and interactions with the transfer system. The terms of reference stipulate that the review will comprehensively examine Australia's tax system and make recommendations to 'create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes' (Treasury 2009a).

To date, the Henry review has released several consultation papers on the architecture of Australia's tax and transfer system, addressing a range of economic issues relating to the tax system. Taxation arrangements specific to executive remuneration have not been covered. The final report of the review panel with recommendations for reform is to be submitted to the Treasurer in December 2009.

Box 10.2 **Recent inquiries covering taxation of employee equity**

In addition to the Future Tax System Review (box 10.1), other recent inquiries where stakeholders made submissions regarding taxation arrangements for employee equity include:

- The Australian Prudential Regulation Authority's (APRA) revised governance requirements for APRA-regulated institutions — a consultation paper was released in May 2009, and a second package comprising revised draft versions of governance standards and an associated draft prudential practice guide was released in early September. Final prudential standards and the associated prudential practice guide were released on 30 November 2009 and take effect from 1 April 2010.
- Treasury Consultation into Reform of the Taxation of Employee Share Schemes — Consultation process on a consultation paper and exposure draft bill jointly released by the Treasurer and the Assistant Treasurer on 5 June 2009. The final taxation treatment was announced on 1 July 2009 and an exposure draft was released on 14 August 2009. On 21 October, the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 was passed by both houses on 2 December 2009.
- Senate Economics Committee Inquiry into the operation of employee share schemes in Australia — this inquiry commenced in June 2009, and the final report was released on 17 August 2009.

remuneration more broadly. Recommendations relating to taxation arrangements are provided in chapter 11.

10.2 Taxation of equity-based payments

Equity-based payments refer to remuneration provided in the form of shares or rights to shares (chapter 7). Given a significant proportion of executive pay is provided in the form of equity, taxation arrangements for this form of income are particularly relevant when examining issues of executive remuneration. Taxation of equity-based payments can be complex:

- there are several points in time at which tax can be applied
- income must be qualified as either employment income or capital income
- the 'value' of the equity can be difficult to determine where the rights provided are subject to vesting requirements or contingencies, particularly for non-traded equities (such as executive stock options).

Current arrangements

The timing of taxation of equity-based payments can have a significant influence on the total amount of tax paid. The general principle applied in Australia is that where a taxpayer acquires a share or right as employment income, the assessable income of the taxpayer includes the difference between the market value of the share or right and the amount paid to acquire it (this value is called the 'discount'). The actual point at which income tax is payable can vary. Irrespective of the point at which income tax is applied, capital gains tax may be payable on sale of the share or right (while a 'right' is not explicitly defined in the legislation it is generally taken to mean an option or performance right) if it has appreciated in value from the time its receipt was first recognised for tax purposes.

Recent changes to tax law for concessionary taxation of equity-based payments

Favourable taxation treatment is available for equity-based payments received through 'approved' employee share schemes under certain conditions. Legislation was first introduced to support employee share schemes in 1974, with the rationale for concessional treatment being 'to ensure better alignment between the interest of the firm and the firm's employees' (Treasury 2009d, p. E3). These concessions are directed at employee share schemes which encourage investment by employees in their employer and which are broadly available to all permanent employees (House of Representatives 2009).

Until 2009, no restrictions were applied on the extent to which executives could access these concessions, beyond those applicable to other employees. However, changes to these provisions announced in the 2009-10 budget (boxes 10.3 and 10.4) limit access to the upfront tax exemption of $1000 to taxpayers with an adjusted taxable income of less than $180 000 (Sherry 2009a). In addition, equity received through employee share plans will be taxed on acquisition unless certain conditions hold, for example:

- equity is at 'real risk of forfeiture'
- equity is provided through an approved salary sacrifice employee share scheme.

Box 10.3 **A final position on taxation of employee share schemes?**

The Government announced changes to the taxation of employee share schemes on 12 May 2009. According to the Assistant Treasurer, the changes were intended 'to help ensure everyone pays their fair share of tax by better targeting eligibility for the employee share scheme tax concessions' and were expected to provide an additional $200 million over the forward estimates (Sherry 2009a, p.1). Furthermore, the explanatory materials for the draft legislation amendments stated that the changes were designed to ensure taxpayers are taxed consistently regardless of the forms of remuneration they receive (House of Representatives 2009).

The changes were highly criticised by a variety of groups and, after a period of community consultation, a revised final 'policy statement' was released on 1 July 2009. The policy statement indicated that new arrangements would apply to all shares and rights acquired on or after 1 July 2009 (Sherry 2009a).

Subsequently, the Assistant Treasurer outlined a three-stage consultation process:

- a two-week public consultation period on a draft Exposure Bill
- a Board of Taxation consultation on:
  - technical issues relating to the Exposure Bill (due one month after its release)
  - the market value of employee share scheme equity and whether employees of start-up, research and development and speculative-type companies should be subject to separate arrangements (due February 2010) (Sherry 2009b).

In August, the Senate Economics References Committee inquiry into taxation arrangements for employee share schemes recommended that the government delay the introduction of changes to tax legislation in order to take note of other reviews in this area, including the Commission's inquiry and the Henry Review, to maintain legislative integrity and coherence (Senate Economics References Committee 2009). However, the Labor Senators' Dissenting Report did not support this recommendation.

On 21 October, the Government introduced legislation based on the policy statement into Parliament. This bill was passed by both houses on 2 December 2009.

This chapter refers to the 'previous' arrangements (taxation treatment prior to 1 July 2009) and the 'new' arrangements (as outlined in the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009).

Under the previous arrangements for taxation of employee share scheme equity, employees who had been issued 'qualifying' equity had the option of choosing the point at which income tax was applied (box 10.4). Figure 10.1 illustrates the taxing points under the previous and new tax laws.

Box 10.4 The changes to taxation of employee share schemes

The arrangements prior to July 2009

Prior to the change, employees who received shares or options under 'qualifying' employee share or option plans were able to elect either to:

- defer when the discount (the difference between the market value of the share or right and the amount paid to acquire it) was assessable as taxable income for up to ten years or
- pay income tax up front and receive a $1000 tax exemption (appendix C).

'Qualifying' employee share schemes must offer ordinary shares, or rights to ordinary shares, in return for employment services. The employee must not consequently have control of more than 5 per cent of the company or be in a position to cast, or control the casting of, more than 5 per cent of the maximum number of votes that might be cast at a general meeting. Additionally, in the case of 'qualifying' shares, at least 75 per cent of permanent employees must be entitled to acquire shares in an employee share scheme offered by the company at that time or at some time previously.

The new arrangements

Under the Government's 1 July 2009 changes, the discount on all shares or rights received through employee share schemes will generally be assessed in the income year in which the shares or rights are acquired. The tax exemption of up to $1000 will be restricted to employees with an adjusted taxable income of less than $180 000. Taxation of equity from employee share schemes will occur at the time of grant, unless one of the following requirements is met:

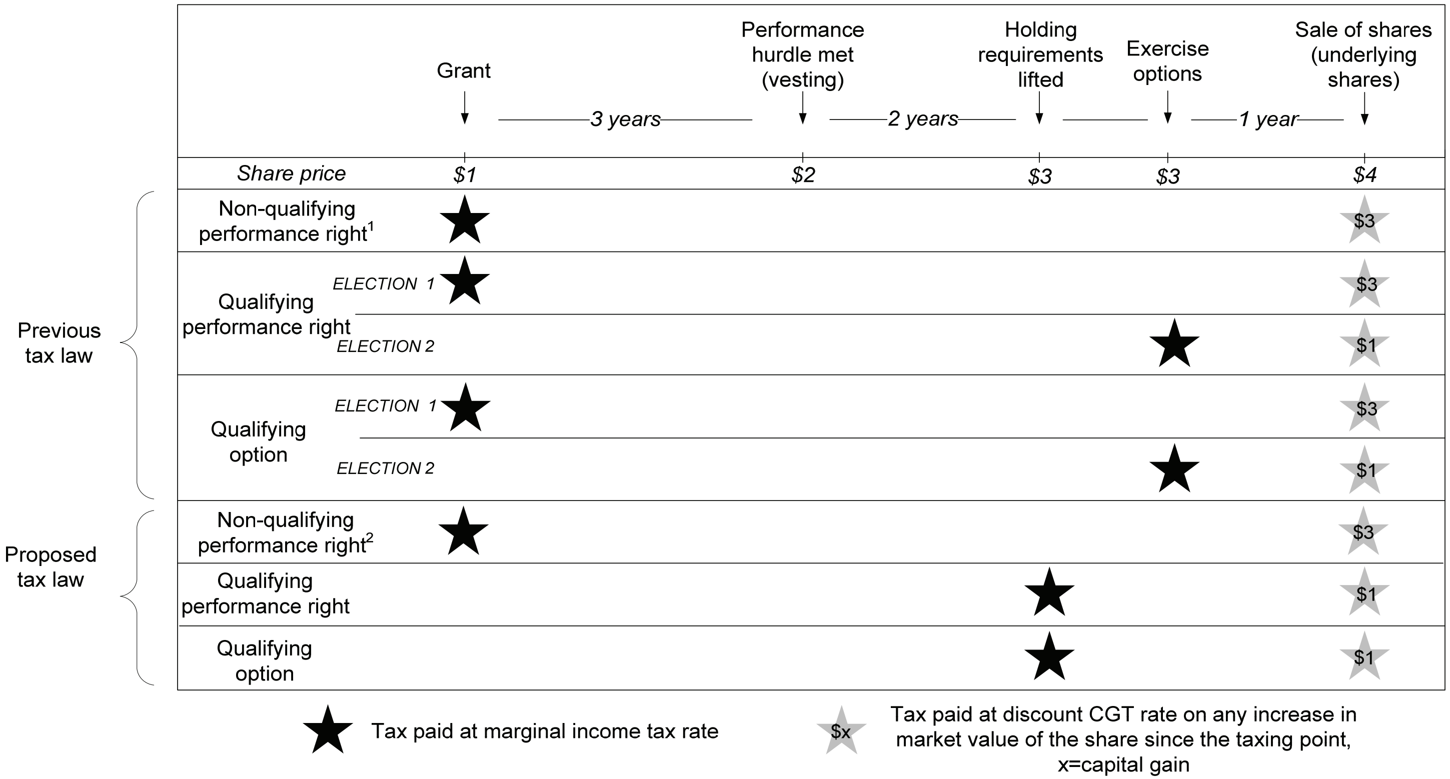
- equity is received through an approved salary sacrifice employee share scheme
  - approved schemes must offer up to $5000 worth of equity in an income year with no risk of forfeiture, meet certain requirements (equivalent to the previous 'qualifying' rules, appendix C) and be clearly distinguished as a deferral scheme
- equity is at 'real risk of forfeiture' and meets certain requirements (equivalent to the previous 'qualifying' rules, appendix C)
  - this includes meaningful performance hurdles or a requirement to serve a minimum term of employment.

Under either of these circumstances, tax can be deferred for up to seven years or until the point where the risk of forfeiture is removed and no genuine restrictions preventing disposal exist or where employment is terminated (whichever occurs first).

In addition, the Government will also introduce annual reporting requirements for employers and a withholding tax applicable in circumstances where the employee does not provide a tax file number or an Australian Business Number to the employer.

These measures will take effect (retrospectively) with respect to shares and rights acquired after 1 July 2009.

Figure 10.1 **Taxing point of equity from employee share schemes under previous and new tax law**



Notes:

Election 1 – pay tax upfront on grant

Election 2 – defer tax

1. A performance right is also known as a ‘zero exercise price option’.
2. This is also equivalent to a qualifying performance right with no performance hurdles.

The Government's first announcement regarding taxation of employee share schemes (in the 2009-10 budget) generated significant concerns among stakeholders. These initial concerns were raised in submissions to this inquiry, in addition to other reviews at the time. A key message from participants was that income taxation should not be levied before the point where the employee is able to sell the share or option (and thus finance the tax bill) (Australian Human Resources Institute, sub. 49; Charles Macek, sub. 55; PricewaterhouseCoopers, sub. 85; KPMG, sub. 95).

After a period of consultation, the Government revised the original proposed changes — where income taxation would occur at grant — to the final arrangements where deferral of income tax is allowed in circumstances where equity or rights are provided through an approved salary sacrifice scheme or where a 'real risk of forfeiture' is applied on the equity or rights (box 10.4). Treasury argues that providing for deferral in these situations recognises that:

- employees utilising salary sacrifice employee share schemes under the existing law will continue to be able to access these schemes with minimal disruption, thus encouraging the broad availability of, and participation in, employee share schemes in Australia (House of Representatives 2009, pp. 42–3)
- the employee may never 'have a chance to realise the economic value of the [employee share scheme] interest' and that having remuneration 'at risk' in this way is entirely consistent with the objective of aligning the interests of employees and employers (House of Representatives 2009, p. 17).

Treasury also noted that the limited deferral period of seven years is aimed at ensuring fairness, aligning interests of the employer and employee and preserving the integrity of the tax system by preventing unlimited deferral of tax on significant remuneration (House of Representatives 2009, p. 46).

Under the new arrangements, 'real risk of forfeiture' refers to situations where a share or right is subject to meaningful performance hurdles or a minimum term of employment requirement (appendix C). A restriction that prevents the employee from disposing of a share or right for a specified period of time does not constitute a 'real risk of forfeiture' and thus does not enable deferral of tax by itself.

Under the new arrangements, 'risk of forfeiture' is an entry requirement to defer tax, and once it is satisfied, tax can be deferred until the risk of forfeiture is lifted and genuine restrictions preventing disposal of the share or right no longer apply. In this context, 'genuine restrictions' can include conditions of the employee share scheme that contractually prohibit disposal of shares, an internal company policy with serious and enforced consequences for breaches, or where disposal of the equity is a criminal offence (for example, where disposal would infringe insider trading laws).

In the case of an option, tax can be deferred until the point that there is no real risk of forfeiture of the right or the underlying share and any genuine restrictions preventing disposal or exercise of the right or disposal of the underlying shares no longer apply. The intention is for tax to be due at the point where the taxpayer can take some action to realise the benefit, irrespective of whether they choose to do so (House of Representatives 2009).

It should be noted that for ‘real risk of forfeiture’ to trigger tax deferral, certain conditions must be fulfilled. These are equivalent to the ‘qualifying’ rules under the previous Division 13A, *Income Tax Assessment Act 1936* (Cwlth). Thus, where equity-based payments are not provided in the form of ordinary equity, or would result in the executive controlling 5 per cent or greater of the company, deferral is not allowed. In addition, for shares, the company must provide equity through employee share schemes in a ‘non-discriminatory’ manner. Thus, there are some cases where executives may face a ‘real risk of forfeiture’ of their equity, but not have access to the tax deferral concession and income tax will be due at grant.

Some key issues

The appropriate taxing point for equity-based payments

In the case of equity-based payments, there are generally four points where taxation may occur: at grant, at vesting (once restrictions on the option or share are removed), at exercise (for options) and at sale (box 10.5). However, it is more

Box 10.5 **International taxation treatment of equity-based payments**

In most OECD countries, equity-based payments are generally treated as ordinary employment income and taxed at income tax rates with capital gains tax payable on sale of the asset. However, in some jurisdictions — Poland (for all schemes) and Denmark, United Kingdom, Ireland and the United States (for concessionary schemes only) — employee options are taxed as capital gains rather than employment income (OECD 2005).

Concessionary arrangements for employee share schemes in other jurisdictions may provide for equity-based payment income to be taxed at capital gains rates and not as employment income (as is the case in the examples above), permit a deferral of income tax or provide a tax exemption. Removal of ‘risk of forfeiture’ is used as a taxing point in other jurisdictions, including the United States and the United Kingdom. However, it is not always defined in the same way as in Australia.

common in other countries for income tax to be levied on employee share scheme equity at *exercise* with treatment varying for concessional plans (appendix C provides further details about the different approaches taken internationally).

A general principle of income taxation is that it should apply in the year that income is derived. A conceptually neutral income tax system would tax taxpayers on the value they receive, irrespective of the form in which that value is provided (box 10.6). Thus, a taxpayer who received $100 000 in cash income, and chose to use this to purchase company shares, should be taxed in the same way as an

Box 10.6 **Defining income**

From an economic perspective, income is a material gain to somebody during a specified period and measured according to objective market standards (Simons 1938). Thus, an economic definition of income does not make a distinction about the source of the income or whether it has actually been realised. Under this definition, gains from labour, capital, gifts and increases in the value of an asset are all treated the same. Thus, for example, the increased value of a family home constitutes economic income, irrespective of whether this gain is realised (Waincymer 1993).

The most commonly-accepted economic measure of income for the base of income tax is attributed to Haig and Simons. Simons defined personal income as:

> … the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. (1938, p. 50)

This definition treats individuals with different sources of income uniformly and does not affect decisions about how to allocate resources to the generation of income.

However, in practice, this definition is not always applied in income taxation, for both administrative and political reasons (Waincymer 1993). For example, a range of non-market activities generate 'imputed income' — which relates to the potential income of property or labour used for personal purposes — that under the Haig-Simons definition should be included in the income tax base. An example of this would be various home production activities such as cleaning or maintenance. While imputed rent from owner-occupied housing has been seriously considered for inclusion in the tax base in some countries (and was taxed in Australia between 1915 and 1923), imputed income is taxed in few cases.

The economic definition of income does not distinguish between realised and unrealised increases in wealth. However, measurement of all unrealised income can pose significant administrative problems. It can be difficult to determine whether an economic gain or loss has arisen. And the gain/loss may be difficult to measure prior to realisation. A related difficulty involves situations where the taxpayer has no other funds (besides the asset) from which to pay the tax — for example, farmers or small business owners. As a result, most income tax systems include capital gains in the tax base only when they are realised. This may also serve to encourage the accumulation and transmission of wealth.

employee who received pay in the form of company shares valued at $100 000. However, several complications arise in the application of this principle to taxation of equity-based payments — particularly where an employee may be granted equity but receipt is dependent on certain conditions.

Deferral of taxation

The point in time at which income tax is paid can significantly influence the total amount of tax paid on equity-based payments. In Australia, an individual can receive a discount on capital gains of 50 per cent for an asset that has been held for 12 months or more. Thus, assuming that the share price increases, where employees pay income tax up-front at grant on equity-based remuneration (which is held for 12 months), they are able to shift a greater proportion of their taxable income to be taxed as capital gains rather than as employment income, relative to employees that pay tax at exercise or vesting. This may have provided an incentive for employees to be paid in equity under the previous arrangements. The impact of income tax at grant or at vesting is illustrated in box 10.7.

Deferral of income taxation is effectively equivalent to the government providing the employee with an interest-free loan for the amount of tax due over the period of deferral. However, deferral of tax accompanies a deferral of receipt of the employee's remuneration which reduces the value of the remuneration provided to the employee relative to receiving the remuneration immediately.

The recent changes to employee share schemes mean that tax deferral on equity-based payments will henceforth stem from share scheme design not the employee's election.

Time limit of deferral

The new arrangements enable deferral of taxation on eligible equity-based payments for a maximum duration of seven years. Under the previous legislation this limit was ten years (box 10.4). Regnan (sub. DD 159) argued that in order to promote better alignment between executives and long-term owners (who invest for well beyond seven years in a company) this limit should be a minimum of ten years.

The time limit chosen for deferral is an arbitrary point and is intended to prevent unlimited deferral of tax on significant remuneration (House of Representatives 2009). While extension of this time limit would enable employers to require executives to retain 'skin in the game' for a longer period (and share in the upsides and downsides experienced by shareholders), it also extends the period over which employees can defer paying tax. Currently, the Commission understands that performance-linked remuneration generally vests after three to four years. Thus, within this context, the seven-year limit in practice would provide room to increase the period of time over which remuneration vests without taxation being imposed prior to vesting.

Box 10.7 **Total tax payable on shares with upfront payment or deferral**

The diagram below depicts the two options that were available to employees under the previous arrangements (either pay tax upfront on grant or defer for up to ten years) under two scenarios (a rising share price and a falling share price).

In the first scenario, where an employee pays income tax upfront on the 500 000 shares at the point of grant (where shares are worth $1 each) the amount of tax due is $225 000. The employee then pays tax on the discounted capital gain on sale of the shares a year after the shares vest. The total discounted tax payable is $325 790. The total net benefit to the taxpayer is the value of the shares at year 3 ($1 000 000) less the amount of tax paid.

Thus less total tax is paid in the first scenario where a taxpayer pays tax upfront than where the taxpayer defers income tax until their shares vest. However, the deferral of tax confers a benefit equivalent to an interest free loan from the government to the taxpayer. The benefit from this loan is assumed to be equivalent to the return that the taxpayer would receive by investing the $225 000 at the Treasury 10-year bond rate for one year (equivalent to discounted present value of $12 030). This is then taken into account when calculating the employee’s total net benefit in year 3.

Under the second scenario, the employee who pays income tax upfront pays a higher amount of income tax than the employee that elects to defer. Further, the employee that elects to defer taxation also receives a higher benefit due to the benefit from deferral of taxation for one year. Under both options a capital loss is recorded. The employee that chooses to pay income tax upfront records a larger capital loss (that can be used to off-set capital gains in a subsequent year) than the employee who chooses to defer taxation.

	Grant 500 000 shares	*1 year*	Shares vest (performance hurdle met)	*1 year*	Sale of shares	**Total tax paid**	**Total net benefit**
Share price	*$1.00*		*$1.50*		*$2.00*		
Pay income tax up-front	$225 000 Income tax				$100 790 CGT	$325 790	$674 210
Defer tax until vesting	*Interest free loan = $225 000*		$319 450 Income tax		$50 395 CGT	$369 845	$642 190
Share price	*$1.00*		*$0.75*		*$0.50*		
Pay income tax up-front	$225 000 Income tax				$250 000 capital loss	$225 000	$25 000
Defer tax until vesting	*Interest free loan = $225 000*		$159 725 Income tax		$125 000 capital loss	$159 725	$102 310

Notes: Assumes a marginal tax rate of 45%. Values discounted using Treasury 10 year bond rate of 5.65%.
As shares are held for one year the CGT discount applies on sale.

Taxation of equity-based payments at termination of employment

Generally, income tax on equity-based payments is payable at termination of employment even where a 'real risk of forfeiture' exists (this was also the case under the previous taxation arrangements for equity-based payments). This creates a situation where income tax can be due on an equity-based payment at a point where a 'real risk of forfeiture' is still in place.

Inquiry participants observed that this approach provides a disincentive for deferring equity over the longer term (box 10.8). Several participants warned that companies were structuring remuneration packages to vest at termination and consequently creating an incentive for executives to maximise the share price at this point with potentially perverse effects. This may also change an executive's attitude to risk. In particular, it could serve to encourage more risk-averse behaviour towards the end of an executive's tenure. Some also argued that the requirement to pay tax at termination of employment could lead to employers increasing other components of remuneration, such as short-term incentives or base pay, in place of long-term deferred equity.

In November 2009, the Australian Prudential Regulation Authority (APRA) released a revised Prudential Practice Guide for remuneration that seeks to align Australian principles with recently-developed international principles on sound remuneration practices, in particular those of the Financial Stability Forum. In response to concerns regarding taxation of equity at termination of employment, APRA noted that 'it is inevitable that the design of remuneration arrangements will be influenced by taxation legislation. Taxation requirements may interact with APRA's principles in a manner that requires, for example, that an institution permit the partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component'. APRA expects all such arrangements to be adequately documented in the remuneration policy and to be consistent with the governance standards (APRA 2009c).

In its finalised Prudential Practice Guide released in November, APRA cautions that partial vesting could lead to perverse outcomes such as where an employee ends up receiving a benefit that they are otherwise not entitled to. For example, APRA (2009c) cites the possibility that where partial vesting is allowed, and later (after termination) it arises that the performance hurdles are not met and full vesting does not occur, the institution may be left attempting to recoup the released payment from the ex-employee.

APRA concludes that it would 'not be prudent practice for deferred payments to vest automatically upon cessation of employment with a regulated institution'. It argues that it is preferable for deferral and vesting arrangements to remain in place post termination of employment and that cessation of employment as a taxation point for deferred share schemes 'has the potential to cause conflict between prudent deferral and taxation requirements' (APRA 2009c, p. 13).

In its Consultation Paper on the Reform of the Taxation of Employee Share Schemes, Treasury noted that APRA would prefer termination of employment not to trigger a complete vesting in shares of the departing employee. Nevertheless, Treasury maintained that termination of employment should remain a taxation point for employee share scheme equity, as otherwise tax integrity issues would arise. For example, employees may move overseas after ceasing employment, creating difficulties for the Australian Tax Office to collect tax (Treasury 2009d). However, several participants submitted that the proposed improvements to reporting requirements and withholding arrangements should address this problem (Ernst and Young 2009; KPMG, sub. DD145; PricewaterhouseCoopers 2009).

Currently, corporate governance principles are being revised internationally, acknowledging the importance of aligning executive remuneration with long-term shareholder value. This has been emphasised by the Financial Stability Forum in its

Box 10.8 **Inquiry participants' views on taxation of equity-based payments at termination of employment**

Many participants argued that taxing equity-based payments at termination encourages short-termism and provides a disincentive to put in place arrangements to manage risk for sustainable long-term returns (Guerdon Associates 2009a; Origin Energy, sub. 93). Macquarie noted that this runs counter to remuneration best practice, particularly for financial institutions (sub. DD157). Regnan maintained that reform of any tax disincentives to holding equity through retirement is fundamental to bringing about better aligned executive remuneration practices (sub. 72). The Australian Institute of Company Directors also noted that taxing equity-based payments on termination puts upward pressure on lump-sum payments (sub. 59).

Both Origin Energy (sub. 93), the Australian Bankers' Association (sub. 70) and PricewaterhouseCoopers (sub. DD138) cautioned that, in some cases, boards are waiving vesting periods to enable executives to sell shares and pay their tax bill. Guerdon Associates noted that it is common practice for boards, when designing packages for executives approaching retirement, to:

- substitute short-term cash incentives for long-term equity
- have any long-term, performance-contingent equity vest on retirement, perhaps with the quantum pro-rated in proportion to the part of the performance period completed
- increase cash salary in lieu of equity-based remuneration (Guerdon Associates 2009a, p. 3).

Principles for Sound Compensation Practices, and subsequently by the G-20 and European Union. To achieve improved alignment, requiring executives to hold equity post-termination is generally considered to be best practice. This view is also held in Australia. For example, the Australian Shareholders' Association (sub. 54) supports executives holding equity for a period of at least two years after departure, and Regnan (sub. 72) supports a policy where all executive remuneration above a pre-determined threshold should take the form of common equity vesting over a period of five to ten years (box 10.9).

In its Prudential Practice Guidelines, APRA noted that 'particular attention needs to be given to the length of the deferral periods of equity-related remuneration components. Ideally, executives will maintain a long-term view, even when approaching the end of their period of employment' (2009c, p. 15). However, levying tax at point of termination would undoubtedly work against this objective, particularly in the period approaching the end of an employment contract.

The extent of this disincentive is likely to vary on a case by case basis depending on a particular employee's preferences to pay tax without liquidating the asset (in general, the decision to borrow, liquidate the asset or use other funds to finance a tax bill will be made on the basis of portfolio choice) and his or her expectations regarding the future share price. Permitting the partial vesting of an amount to cover taxation obligations addresses concerns to a certain extent. However, it is a compromise, risks creating a situation where an employee is granted a portion of their payment without fully meeting performance requirements and does not completely counter the fact that current law provides an incentive for remuneration design contrary to international best practice approaches to corporate governance.

From a theoretical, tax-neutral perspective, income tax on equity-based payments should be applied at grant. However, due to the difficulties in valuing performance-contingent, unlisted rights and the Government's expressed intention to provide concessions for broader employee share ownership, deferral of income taxation is permitted under certain circumstances. Within this context there is little rationale for ceasing tax deferral at termination of employment. It is not clear why two employees should be treated differently where they hold identical, unvested deferred rights and one retires and the other continues working. Thus, while there is a rationale for applying income taxation at grant, vesting or exercise, this is not the case for termination of employment. Further, unlike at grant, vesting or exercise, termination of employment is a point that is open to manipulation.

Box 10.9 **Regnan's approach to deferred pay**

In its submission, Regnan presented a remuneration reform proposal that aims to align executive incentives with long-term sustainable company growth. It stated 'executives make decisions whose effects in many cases outlast their tenure and we believe that alignment of executive rewards to better reflect this reality would strengthen Australia's governance practice' (sub. 72, p. 3).

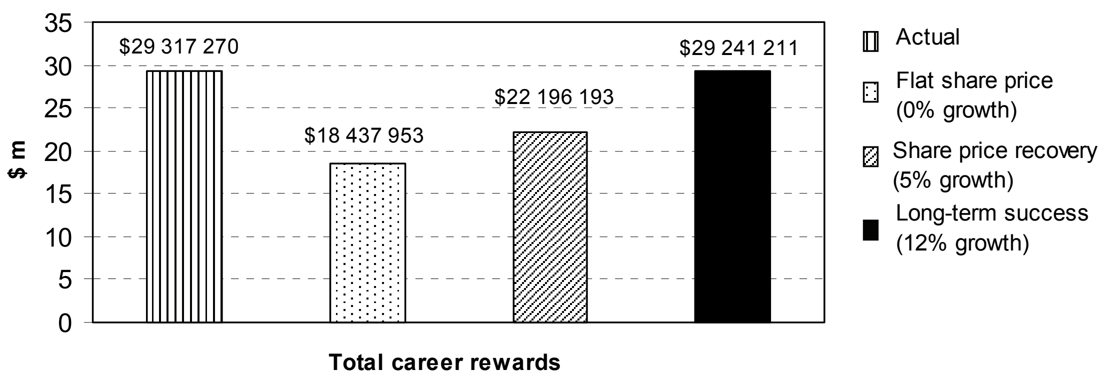
Key features of the proposal are:

- boards to set a threshold on annual cash remuneration, which may differ by executive (termination payments would be part of this threshold)
- all remuneration above the threshold to be paid in equity, vesting after five years, in five equal annual tranches, regardless of continued employment
- a binding shareholder vote on termination payments above 12 months' base salary.

Regnan argues that its proposal still gives boards the discretion to determine remuneration, including overall quantum, short- and long-term incentives and performance hurdles. In the case of short-term incentives, this would allow 'executives to earn in the short term, but collect in the long term' (sub. 72, attachment, p. 2).

Regnan applied its proposal to some recent CEO departures, focusing on remuneration for the preceding five years and assuming a $1.2m cash threshold and various future share price movements to calculate 'total career reward'. The following figure was presented for the departing Transurban CEO in 2008 (termination payments were excluded as Regnan assumed shareholders would have rejected the $5.2m payment made by Transurban).

Total career reward (not including termination payment)



There are indications that the rule regarding taxation at termination of employment has been overcome in the past. A 2006 class ruling for BHP Billiton by the Australian Taxation Office found that, where rights provided under employee share schemes are provided at 'the discretion' of the employer, the right is not considered to be 'a right to acquire a share' within Division 13A (ATO 2006). Under the BHP

Billiton scheme, the remuneration committee retains discretion to deny award of equity even where performance requirements are met. The Australian Taxation Office ruled that BHP Billiton employees participating in the company's 'Long Term Incentive Plan' were therefore considered to acquire a right for the purposes of Division 13A on the date that BHP Billiton advises employees whether they have satisfied the performance hurdles. Thus, participating employees do not pay income tax on the rights until vesting. This applies to all participants in the scheme including employees who no longer work for BHP Billiton.

Regnan — who strongly argued that boards should be unconstrained in terms of the period over which they align shareholder and executive interests through remuneration arrangements — noted that it and other shareholders will be forced to go to Australian company chairs and say:

> We're not happy with what you're doing and regardless of the cessation of employment, we demand that you put in place a remuneration system that has serious risk of forfeiture … and you're going to have to get a public tax ruling in relation to the remuneration system and you're going to have to do it one by one … (DD trans., p. 69)

The taxation provisions for employee share schemes are not specifically designed for executives and must apply to all Australian employees. Furthermore, the concessions that enable deferral of tax for equity-based payments are targeted towards schemes that encourage broad employee share ownership. It is questionable whether it is beneficial for all permanent employees to have aligned incentives with their employer post termination, and unlikely that employers would have such arrangements with non-executive employees. Thus, changing this rule is likely to primarily extend concessional treatment to executives and not affect other employees receiving equity more broadly.

Treasury argues that changing the tax law will have costs, particularly related to maintaining the integrity of the tax system and achieving compliance. Further, as deferral of tax beyond grant is equivalent, when compared to the status quo, to the provision of an interest-free loan from the government, the extension of current deferral arrangements will have revenue impacts.

Nevertheless, the requirement that employees must pay income tax on equity at termination of employment creates a disincentive to defer equity beyond retirement for executives and is thus contrary to best practice governance promoted in Australia by the prudential regulator and overseas. Further, it maintains an inconsistency in the Government's approach where taxation on performance-contingent, unlisted rights can be deferred until vesting where the employee continues employment, but not in circumstances where this employment ceases. In circumstances where deferral is deemed appropriate during employment it is not clear why it is no longer appropriate after termination.

The Commission notes that removing termination of employment as a taxing point would reduce projected savings over the forward estimates from the tax law changes and lead to efficiency costs due to the need to source revenue from elsewhere. However, it is not clear to what extent retaining this taxing point would contribute to projected savings, particularly where organisations seek tax rulings to circumvent this rule. In addition, there are several factors that could minimise the impact on revenue from removing this taxing point:

- removal could be applied only where equity is at risk of forfeiture (and not to salary sacrifice schemes)
- the government's recent changes include measures aimed to improve integrity of employee share schemes (including employer reporting and a withholding tax)
- it is unlikely that in all cases taxpayers will defer tax for the full seven years.

There are also potential efficiency costs in relation to retaining the policy, particularly where accounting for the possible perverse effects of altering an executive's attitude to risk prior to termination. As argued by the Australian Securities Exchange (sub. DD142), 'a taxation policy that drives remuneration design and practices that are inconsistent with corporate governance policy is both inappropriate and counterproductive' (p. 9).

From the executive's perspective, taxation is deferred only to the extent the remuneration benefit is deferred and thus removing termination of employment as a taxing point is unlikely to spur arrangements whereby tax is deferred indefinitely.

Valuation of options

An option provides the holder with the right to purchase shares at an agreed 'strike' price within a predetermined period. An executive will only exercise an option where the strike price is below the current market value of the stock (were this not the case, the executive could do better buying the shares on the market). It is the difference between the strike price and the (potential) market price that gives rise to a benefit to the executive (appendix E).

The value of an option is determined by calculating the expected future payoff (which, being contingent on the share price and potentially other variables as well, cannot be known with certainty) discounted to the present. The method used to calculate the market value of an option (if it is not quoted on an approved stock exchange on the day of acquisition) under the *Income Tax Assessment Act 1936* is based on a hybrid of financial valuation models, including Black-Scholes (Treasury 2009b) (appendix E). The estimated value depends on the market value of the share on that particular day, the exercise price and the expiry date of the option. This valuation does not take into account the impact of performance hurdles.

Hence, the greater the likelihood that the option will not be 'in the money' when the employee is able to exercise it, the lower the value ascribed to the option. Consequently, situations can arise where executives are granted options and pay tax up-front on a fraction of the current market price of the relevant shares.

It is not clear whether the valuation rules for options have resulted in companies favouring options over other forms of remuneration. The Commission understands that there has been a reduction in the use of options over the past decade. However, while this can be verified from the period 2002 to 2006, the data for 2007 suggest otherwise (table 10.1). The use of performance rights (which are valued the same as shares granted for free) has steadily increased. One of the reasons that other forms of remuneration would be preferred to options is that the value of the option reflects the risk and uncertainty to the executive of the option's future value. Thus, while the executive's tax bill may be reduced, the lower tax value reflects a lower expected total value of remuneration to the executive.

As part of the recent changes to the taxation of employee share schemes, the government has announced that the Board of Taxation will review the valuation rules for options (Sherry 2009b). In the interim, taxpayers can use the existing rules in relation to valuing non-traded rights, or opt to use a valuation methodology that fits their circumstances and has the lowest compliance costs (House of Representatives 2009). In its evidence to the Senate Economics References

Table 10.1 **Components of remuneration as a proportion of total remuneration**

<table>
<tr><th>Component of remuneration</th><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>2005</th><th>2006</th><th>2007</th></tr>
<tr><td></td><td>%</td><td>%</td><td>%</td><td>%</td><td>%</td><td>%</td><td>%</td></tr>
<tr><td>Options</td><td>13.3</td><td>19.9</td><td>10.8</td><td>7.7</td><td>7.3</td><td>6.1</td><td>9.2</td></tr>
<tr><td>Performance rights</td><td rowspan="4">10.3</td><td rowspan="4">8.7</td><td>4.3</td><td>4.0</td><td>5.6</td><td>8.3</td><td>8.8</td></tr>
<tr><td>Deferred shares</td><td>2.5</td><td>3.4</td><td>6.1</td><td>3.7</td><td>5.9</td></tr>
<tr><td>Loan funded share schemes</td><td>0.8</td><td>0.3</td><td>0.5</td><td>1.6</td><td>0.4</td></tr>
<tr><td>Free shares</td><td>–</td><td>4.4</td><td>6.1</td><td>–</td><td>–</td></tr>
</table>

– Nil or rounded to zero.

Source: ACSI (2008b).

Committee on Employee Share Schemes, Treasury (2009b) states that the valuation method used in the existing law for unlisted rights 'significantly under-values those rights'. Furthermore, that the valuation methodology provides an 'embedded concession within the law' and that one issue to be reviewed is whether this concession is appropriate (Treasury 2009b, p. E14). In its submission to the Senate Inquiry, Treasury states that 'the general principle of market value should apply in determining the market value of a listed and unlisted security in the first instance. However, the new framework will allow the Government to provide for a 'rule-of-thumb' in regulations' (2009d, p. 25).

The Commission considers that provisions to value options for tax purposes should require an estimate of the future expected value discounted to the present. While this may result in the value of an option for taxation purposes being a percentage of the current market price of the underlying share, this is not a distinction in itself: it merely recognises the uncertainty regarding the future market price of the underlying share and thus the real benefit to the executive of holding that option.

The Government has indicated that a refund will be available for tax paid on forfeited equity where the employee had no choice but to forfeit the employee share scheme equity, except where that choice was to cease employment, and where the conditions of the scheme were not constructed to protect the employee from market risk (House of Representatives 2009). Previously, a refund was available on tax payable irrespective of the reason for forfeiture. Several participants considered that the recent changes to the refund rules are inappropriate (Ernst and Young 2009; Guerdon Associates 2009a; KPMG 2009b). Rio Tinto argued that:

> … as the taxing time can arise in advance of the employee being able to sell the shares, we submit that the phrase 'a choice made by the individual' should be clearly defined in the legislation as not including options which were never in the money during the period when the employee was not prohibited from exercising them. (2009, p. E19)

Given the current approach to option valuation under the tax law, the Government's position on tax refunds is considered to be appropriate. Provision of a tax refund where the employee does not exercise an option as it is 'underwater', would mean that the government was insulating the taxpayer from a market risk that was taken into account in the valuation of the option at the point that tax was paid. Where valuation methods also take into account the uncertainty that the employee may not receive the equity or right due to performance hurdles (as is the case for accounting fair values where performance hurdles are market-related) no refund would be necessary where performance hurdles are not met.

Taxation of options

Several participants have argued that options subject to real risk of forfeiture should be taxed at exercise (Guerdon Associates, sub. DD163; Institute of Chartered Accountants, sub. DD146; Origin, sub. DD129). The Commission notes that under the new legislation the taxation of options can occur at a range of points, depending on the conditions of the scheme (that is, whether there is a risk of forfeiture on the rights or underlying shares and any genuine restriction on disposing the right, exercising the right and disposing of the underlying shares).

Guerdon Associates (sub. DD163) argued that personal income tax should only be levied on income actually realised by the employee. In particular, it is concerned that the government's taxation of options at vesting will 'severely hamper Australia's ability to create sources of new growth' as it will impinge on the ability of start-up companies to attract talented staff by providing options (with no risk of forfeiture) in lieu of salary. While Guerdon acknowledges that the government has asked the Board of Taxation to examine whether employees of start-up, research and development and speculative-type companies should be subject to separate taxation arrangements, it believes a fundamental change to the new arrangements will be required.

The Commission considers that once there is no longer any risk of the granted rights being forfeited or any further genuine restrictions on their disposal the employee has received income (in the form of equity). The decision of whether to realise equity or how to finance any tax bill will be made on the basis of portfolio choice and does not alter the fact that the employee has received a benefit for their labour.

Similarly, where employee share scheme options vest 'underwater', these options still confer an opportunity for benefit to the employee and have value. The value of 'underwater' options will be significantly lower than 'in the money' options — and the amount of tax payable will accordingly be less. Only requiring tax to be paid where the underlying shares increase to a point where the option is 'in the money' and is realised would protect the employee from down-side market risk and thus provide a significant concession.

Salary sacrifice schemes

The new legislation also allows for deferral of taxation where equity is provided through an eligible salary sacrifice scheme, so that employees accessing such arrangements under the existing law can continue to do so with minimal disruption. Equity-based payments made through eligible schemes must be in shares and not rights. However, both shares and rights are able to be offered where they are at risk of forfeiture (for example in a 'matching scheme', see appendix C). As such, the rationale for allowing deferral of taxation beyond grant for shares through salary sacrifice is not related to the fact that there is uncertainty that the employee may actually receive the benefit, but rather it is a concession to encourage the use of these schemes. Deferral of tax under eligible salary sacrifice arrangements is limited to $5000 per employee per employment relationship in order to provide a relatively more attractive concession for low and middle income earners (House of Representatives 2009).

Under the new arrangements it is likely that non-executive directors who are encouraged to fee-sacrifice in return for company shares will be required to pay tax upfront on grant of these shares, where the value of shares received is over $5000. Some participants have argued that this is counter to good governance principles that encourage non-executive directors to hold shares subject to holding requirements but without performance requirements attached (Chartered Secretaries Australia, sub. DD147; Ernst and Young 2009; Institute of Chartered Accountants, sub. DD146) (chapter 6). However, allowing a taxpayer to defer paying income tax beyond the point when shares are granted where there is no risk of forfeiture provides a benefit to the taxpayer equivalent to an interest-free loan from the government for the period of deferral. While there may be good corporate governance rationales for non-executive directors to hold company equity over their directorship term, it is not clear that a concession should be provided to encourage them to do so.

10.3 Treatment of termination payments

Current arrangements

There are several tax concessions that relate to termination payments in Australia. The concessions are capped and can vary according to the reason for termination and the length of service and age of the employee. This chapter will examine taxation issues relating to termination payments. The Government's changes regarding termination payments are discussed in chapter 7.

Payments made as a consequence of termination of employment, and received within 12 months of termination, are treated as 'Employment Termination Payments'. These payments are made on retirement, disablement, death, resignation or involuntary termination and can include: payment in lieu of notice, payment for unused rostered days off or unused sick leave, 'golden handshake' or gratuity payments, compensation for loss of job, payments for loss of future superannuation payments, payments in respect of a genuine redundancy or paid under an early retirement scheme that exceed the tax-free limit (ATO 2007; section 82.135, *Income Tax Assessment Act 1997* (Cwlth)) (appendix C).

Employment termination payments are concessionally taxed up to a cap of $140 000 (for the 2007-08 year indexed annually), at a rate of:

- 15 per cent for a recipient at their 'preservation age'
- 30 per cent for a recipient below their 'preservation age'.

Payments in excess of the cap are taxed at the normal marginal rate.

Unlike in other jurisdictions, such as the United States, there is no explicit tax treatment for executives in relation to termination payments in Australia (box 10.10). While the concession associated with Employment Termination Payments is available to executives, other concessions such as those for genuine redundancy payments and early retirement schemes (appendix C) are unlikely to be applicable.

Some issues

There has been significant community concern regarding large termination payments granted during or following periods of poor company performance, which are commonly perceived as 'rewards for failure' (chapters 1 and 7). In response to this, there have been suggestions that Australia could impose additional tax on termination payments that exceed certain thresholds, as is the case in the United States and the Netherlands (David Peetz, sub. 50).

In the United States — where there is a 20 per cent tax on 'excess golden parachute payments' (box 10.10) — there is evidence that the restrictions on termination payments have contributed to substantial increases in termination payments through 'gross-ups' (box 10.11). That is, an initiative intended to constrain executive remuneration through the use of a tax on the termination component has resulted in pre-tax executive remuneration increasing. This would be an expected outcome where demand for executives is inelastic, such that increases in taxation result in increases in remuneration to leave after-tax income unchanged.

International experience indicates that attempts to constrain executive remuneration through taxation measures can also result in:

- a corresponding or greater increase in a different component of executive remuneration (that is not covered by the tax measure)
- changes in the structure of remuneration, which may affect the extent to which remuneration is linked to performance.

Box 10.10 Taxation of termination payments in other countries

United States: Since the mid 1980s the US Government has imposed an additional 20 per cent tax on 'excess golden parachute payments' — termination payments that are paid out due to changes in control or ownership of the corporation and exceed the employee's base salary by 300 per cent. This rule only applies to disqualified individuals who are remunerated in the top 1 per cent of employees in the corporation.

Netherlands: In January 2009, the Dutch Government introduced law that imposes an additional tax of 30 per cent on the employer on the amount by which the termination payment exceeds annual salary where an employee earns more than €500 000 per year.

Portugal: In mid 2009, the Portuguese Government approved a bill — yet to be voted on — that would levy a 35 per cent tax on bonuses paid to an executive on termination of employment where the bonus is not linked to performance targets agreed prior to termination (Nuncio 2009).

Box 10.11 Tax 'gross-ups' and golden parachute payments in the United States

A tax gross-up involves paying the executive additional amounts to cover taxes due and ensures that the executive receives the intended contractually agreed payment once taxes are taken into account.

It is common for employers in the United States to enter into contracts with executives regarding termination payments on change in control of the company. These provisions are typically structured as either a tax gross-up, a 299 per cent parachute payment (so to avoid the 20 per cent tax) or a mixture of the two (McNeil 2004).

As a tax gross-up payment is considered an additional parachute payment, the amount by which the payment is grossed-up up also increases the total amount of tax payable (McNeil 2004). Further, the company also forgoes a corporate tax deduction on the 'excessive' component of the termination payment.

A RiskMetrics study found that the tax on 'excess golden parachute payments' in the United States contributed to substantially increasing parachute payments due to 'gross-up' payments. The average potential gross-up payments (for companies that disclosed these amounts) was US$13.9 million. On average they estimated that tax gross-up payments make up 18 per cent of total potential termination payments (RiskMetrics 2008b).

Several participants addressed this issue. For example, PricewaterhouseCoopers noted that 'the use of taxation law to try to limit the quantum of executive pay is fraught with danger and is likely to produce negative unintended consequences' (sub. 85, p. 2). This view was also supported by the Australian Securities Exchange which noted that the introduction of legislative restrictions and artificial limits on the quantum or the structure of remuneration could be expected to have distorting effects on the market (sub. 64).

In the case of termination payments, an approach that levies an additional tax on executives would not only add complexity, but would likely encourage efforts by executives and their employers to structure remuneration packages to avoid this taxation (and thus encourage substitution to other forms of pay). Such an approach would also raise issues in terms of defining covered 'executives'.

The Commission considers that given the range of significant adverse consequences that can eventuate through such an approach, the tax system should not be used to penalise or limit executive termination payments. Further, the new laws granting shareholders a vote on termination payments above a much reduced threshold level will operate in this space to improve shareholder say on termination payments.

One other proposal received by the Commission regarding termination payments was to limit executives' access to the concessionary treatment currently available to all employees (CGI Glass Lewis and Guerdon Associates, sub. 80). This would involve executives being unable to access the concessionary tax rates on termination payments (for the portion of the payment under $140 000) and the total of their payment being taxed at marginal tax rates.

However, the same difficulties arise. Taxation law that applies additional taxes on executives or renders them ineligible for particular concessions available to all other Australian employees can lead to perverse outcomes regarding both the level and structure of executive remuneration. Further, it is questionable whether the revenue benefit of removing this concession would merit the additional costs and complexity involved.

10.4 Taxation of bonuses

There is currently no special taxation treatment of bonuses in Australia. Where a bonus is provided as a cash payment to an employee, it is taxed as income in the year it is received and subject to marginal tax rates.

Early this year, a bill was passed by the US House of Representatives, and is now being considered in the US Senate, which proposes the imposition of a 90 per cent federal income tax on recipients of any retention payment, incentive payment or other bonus paid after 31 December 2008 by a company or an affiliate of a company that received more than US$5 billion under the Emergency Economic Stabilization Act of 2008.

In December, the UK Chancellor announced plans for a one-off tax on bankers' bonuses as part of the pre-Budget report. The tax will involve a temporary levy (applied from 9 December 2009 to the end of the financial year in April 2010) of 50 per cent on any individual 'discretionary' bonus paid above £25 000 (UK HM Treasury 2009). Thus, bonuses guaranteed by contract are exempt. It is intended that banks, rather than the bankers, pay the levy. Bankers will still pay ordinary income tax on any bonus or salary received.

Some issues

A number of inquiry participants indicated that there was significant community concern with 'windfall remuneration gains' such as bonuses, particularly in times of poor company performance (chapter 7).

However, there was little support for a tax on executive bonuses. CGI Glass Lewis and Guerdon Associates argued that bonuses allow remuneration to be aligned with economic outcomes, so that remuneration can 'increase when results are good and decrease when results are poor' (sub. 80, p. 89). Other participants submitted that short-term incentives, such as bonuses, are essential components of executive remuneration packages and that there is no obvious case why differential tax rules should apply (BHP Billiton, sub. 45).

Further, a penalty tax on bonuses could create increased pressure on boards to raise base pay to compensate executives for reduced bonus pay (Australian Bankers' Association, sub. 70; Australian Shareholders' Association, sub. 54; Woolworths Limited, sub. 91) or to 'gross-up' bonus payments — as occurs in the United States (box 10.11). Any increase in base pay as a result of such a tax would serve to decrease alignment of executive pay with performance, as base pay is paid irrespective of performance (KPMG, sub. 95).

As outlined previously, the use of tax law to constrain one component of executive remuneration is likely to have consequences elsewhere on both the level and structure of remuneration. A tax on executive bonuses would be subject to the same pitfalls as other selective taxation measures, such as the US tax on 'excess golden parachute payments'.

Furthermore, proposals to penalise bonuses overlook the important role of short-term incentives as a component of total remuneration, particularly in turbulent times. There is no reason why this particular component of remuneration should be subject to higher taxes than any other component. The tax system is not the best means to address public concerns regarding windfall bonuses to executives in times of poor company performance.

10.5 Allowable tax deductions for employers

Current arrangements

An Australian employer is entitled to a tax deduction for a cost incurred by the company in gaining or producing income or carrying on a business for the purpose of gaining or producing income (section 8.1, *Income Tax Assessment Act 1997*). Thus, Australian companies are able to claim a deduction for salaries and wages. As the issuance of shares or options will not generally involve any cost to the employer, it is not an eligible deduction in Australia (appendix C). However, where an employer is providing equity to employees under an employee share scheme (which provides eligible employees with access to a $1000 tax exemption) a deduction of up to $1000 per employee is allowed (irrespective of whether the employee is eligible for the $1000 tax exemption due to their income levels).

In 1993, the United States introduced a $1 million limit on employer tax deductions for non-performance based remuneration of the CEO and the four other highest paid officers in the corporation. This limit was introduced to strengthen the relationship between executive remuneration and firm performance (Balsam and Ryan 2008) and to reduce excessive CEO remuneration by increasing the cost to the company (Rose and Wolfram 2000).

Some issues

Several participants suggested that Australia should introduce caps on tax deductions in a similar fashion to the United States (Australian Council of Trade Unions, DD trans., p. 33; Carol Steiner, sub. 6; Construction, Forestry, Mining and Energy Union, sub. 78).

The Australian Council of Trade Unions argue that such an approach would mean 'boards can pay their chief executives whatever they like, but that portion over the threshold comes out of after-tax profits for the company. So it increases the connection between the interests of shareholders and the value for money they get from the executive' (DD trans., p. 33). The Australia Institute also proposed such an approach calling it an 'acceptability cap' where pay above the limit is deemed not to be a legitimate business expense and in turn not tax deductable (sub. DD131, p. 24). David Peetz noted that this would 'return to the community a fraction of the losses associated with excessive growth in executive remuneration' (sub. 50, p. 14). Carol Steiner proposed that all forms of remuneration be included under the tax deductibility cap, with no exceptions for performance-based remuneration as applies in the United States.

The US cap on tax deductibility is widely held to have increased incentive-based remuneration as a proportion of total executive remuneration. While a variety of forms of remuneration can qualify as performance-based, options automatically qualify where the exercise price is set at or above the market price on the date of grant (appendix C). Thus, one consequence of the rule was a significant increase in the use of options for executive remuneration (Balsam and Ryan 2008). Some argued that this increased the pay-for-performance sensitivity of affected firms (Perry and Zenner 2001). Others contended that, while the cap led firms to increase the proportion of performance-related pay relative to non-performance pay, this substitution was minor (Hall and Liebman 2000).

Further, it is posited that — as options encourage greater risk-taking than cash remuneration — one consequence of the significant increase in options remuneration was increased volatility in the US market (CGI Glass Lewis and Guerdon Associates, sub. 80). Similarly, Mercer noted that this legislation created more problems than it solved, and drove up the leverage of at-risk pay (sub. 41). BHP Billiton argued that this tax rule 'was arguably a factor in some of the extremely large equity-based incentives that have been criticised by commentators' (sub. 45, p. 9).

There is also evidence that the tax deductibility cap had the opposite outcome to that intended and actually contributed to significant increases in executive remuneration. Conway (2003) argued that when faced with remuneration in the form of stock options, executives demanded more in options than they would have been paid in money to compensate for the increased risk of holding stock (chapter 4). Further, CGI Glass Lewis and Guerdon Associates contend that the maximum 'sanctioned' amount of US$1 million became a minimum (sub. 80, p. 86). Thus, remuneration of executives who had previously earned below US$1 million increased to the cap level, while executives with remuneration above the cap received increased levels of equity remuneration, and pay levels across the board dramatically increased.

There are also indications that such an initiative can distort the structure of remuneration, with employers favouring specific design elements purely in order to retain tax deductibility of remuneration — such as structuring packages to appear 'performance linked' but which are more akin to base pay (BusinessWeek 2006; Mercer trans., pp. 335–6). However, increased tightening of the rules in terms of what constitutes 'performance-based' may have reduced this somewhat.

In the United States, companies are able to access a business tax deduction for some types of equity-based remuneration (appendix C). This is not the case in Australia, where all equity-based payments are non-deductible. As such, any restriction on company tax deductions in Australia would relate to forms of remuneration that are eligible for a deduction, such as cash. Consequently, a limit on tax deductibility in Australia linked to remuneration above a certain threshold (even if this threshold is on the basis of total remuneration) has the potential to discourage cash remuneration and potentially result in increases in equity-based forms of remuneration.

It seems the US tax deductibility cap is generally recognised as a classic case of policy with detrimental unintended consequences. The Commission considers that the US experience serves to further highlight the risk of prescribing limits on components of executive remuneration.

PART D

IMPLICATIONS FOR PUBLIC POLICY AND CORPORATE CONDUCT

11 The reform package

Key points

- While there had been rapid growth in executive pay (prior to the global financial crisis), the evidence does not indicate widespread failure in remuneration-setting across Australia's 2000 listed companies, nor significant adverse impacts on the performance of the corporate sector as a whole. Nevertheless, some trend and specific remuneration outcomes appear inconsistent with an efficient executive labour market.
  - Poorly designed remuneration arrangements that lead to inappropriate risk taking or short-term behaviour, especially in the finance sector, can have wider economic impacts.
  - Loss of shareholder and community confidence in remuneration could also have adverse consequences for the corporate sector and the wider economy.
- Prescriptive pay constraints (such as caps) are not called for, as they would be impractical, weaken the role of boards and have perverse economic consequences.
- Rather, the way forward is to strengthen corporate governance to improve how boards set remuneration and engage with shareholders.
  - Australia's regulatory and corporate governance framework has evolved in a way that balances prescription with flexibility and has been responsive to changing circumstances.
  - There is scope to make further changes to the framework to promote closer alignment between the interests of executives, shareholders and the boards that represent them.
- Reform should be pursued in five areas.
  - Board capacities: as directors need a mix of skills and experience, undue impediments to board diversity and renewal should be addressed.
  - Conflicts of interest: conflicts exist which are inimical to efficient outcomes and call for more transparency or, in some cases, prohibitions.
  - Remuneration principles: well-designed pay structures facilitate alignment of interests, whereas poorly designed schemes can deliver the opposite.
  - Disclosure: shareholders need to be able to understand more clearly how remuneration practices align with their interests.
  - Shareholder engagement: more effective engagement will require better signalling mechanisms, voting opportunities and processes, and audit trails.

11.1 What sort of policy action is called for?

In responding to the Government's request for recommendations to strengthen 'the framework governing remuneration practices in Australia', the Commission has closely examined available data and trends in executive pay, and considered the potential influences on these.

It is clear from the analysis in part B that the remuneration of senior executives in public companies increased very rapidly overall from the early 1990s, prior to its decline since 2007. It is also evident that this has had much to do with the growth of public companies themselves, in an increasingly competitive and global market environment. Chief executive officer (CEO) pay varies greatly with company size. CEO pay levels for the top 20 companies are currently around 110 times average wages (down from 165 times in 2006-07), but this multiple falls rapidly for smaller companies — the average CEO pay at the next largest 20 companies is about one third less. Generally speaking, Australian executives appear to be paid in line with smaller European countries, but below UK and US standards, the latter being a global outlier.

The evidence also reveals that a key contributor to the growth (and recent fall) in executive pay has been the strong shift to performance-based remuneration, especially (long-term) equity-based incentives. This change has been motivated by the need to align the interests and actions of CEOs and senior executives with the longer term interests of companies and their shareholders. The trend has been particularly marked for the largest companies.

While performance hurdles were generally in place, initially they were relatively 'permissive', often being based loosely on the share price or absolute shareholder return, which translated to comparably rapid pay growth in a buoyant economy. More demanding hurdles were progressively introduced, but the complexity of many of the arrangements no doubt contributed to more 'upside' generally than boards may have anticipated and, in some cases, remuneration payoffs that were seen as grossly excessive.

It also cannot be ruled out that this phenomenon may have been compounded by weaknesses in some boards, or complicity with CEOs, especially for the seemingly more egregious cases of 'reward for failure'. The analysis in part C reveals that while corporate governance in Australia stands up well internationally, there are a number of areas requiring attention, which could well have contributed to such instances.

While the evidence does not point to widespread ongoing failures in remuneration-setting or to significant adverse impacts on the performance of the corporate sector as a whole, it is clear that shareholders and the community have been shaken by revelations of apparent excess and inappropriate practices. Perceptions can be important, as is the reality that some remuneration arrangements, payments and payouts seem to lack a sound basis. If the community came to regard executive pay as the product of poor corporate governance or weak regulation, this could undermine public confidence in the corporate sector itself, potentially detracting from the ability to raise equity capital and distorting the allocation of investment funds. The Commission therefore considers that there is a case for making changes to the system that would enhance its effectiveness and credibility, taking into account the need to minimise potential costs and the scope for unintended consequences.

Regulatory constraints on pay?

A number of participants saw a need to achieve fairer outcomes by imposing regulatory limits on executive remuneration — such as some multiple of others' average earnings or ceilings on tax deductibility — or by having an independent institution with the power to determine pay arrangements (box 11.1). (The UK Government recently proposed a one-off tax on executive bonuses in the banking sector to address its budget deficit — see chapter 10.)

At face value, these proposals may be seen as having the appeal of guaranteeing particular remuneration outcomes in a transparent way. However, like all attempts to set prices administratively, such approaches pose major difficulties in deciding on the 'price' and adjusting it over time such that there is an appropriate balance of supply and demand in the market. Getting this wrong in relation to the senior executives of Australia's largest companies could be very damaging to our national economic interests.

Public companies could be placed at a disadvantage relative to international competitors and private companies in Australia. There would also be the potential for unintended consequences, as companies sought to maintain their competitive position by matching the market through payment forms that escaped the letter of the law.

In any case, it would be difficult to legislate for practicable limits on executive remuneration that would be generally perceived as 'fair' or appropriate. Surveys of retail investors have revealed that while they support CEOs being paid highly for the important role they perform, their conception of 'high' is no more than $500 000 per annum.

Box 11.1 **Pay caps, tribunals or tax changes?**

An executive pay-setting institution

> … the Australian government to establish an Executive Pay Tribunal … [with] power to examine, amend, approve or cancel any executive pay package, contract or termination payment … (Kyneton Branch ALP, sub. 33, pp. 1–2)
>
> … set quantitative limits … related to minimum wages in the community, average wages in the industry, the total package of the nation's head of state or simply set by a remuneration panel … (John Lance, sub. 79, p. 1)

Executive pay caps linked to others' remuneration

> … an absolute cap on the base earnings of executives and directors, of a multiple of ten times the average weekly full-time earnings paid to employees of the enterprise. (Australian Council of Trade Unions (ACTU), sub. 82, p. 3)
>
> … we make the following suggestions for amendments to the Fair Work Act (FWA) … (i). Institute a federal maximum wage order. We suggest … 20 times average weekly earnings could be adopted. (Construction, Forestry, Mining and Energy Union of Australia, sub. 78, p. 10)
>
> … the introduction of a ratio between the average wage and the maximum CEO package of 1:10. (Klaas Woldring, sub. 8, p. 1)
>
> … limit the salary of any Executive or Director of a Publicly Listed company to, say, 50 times the average of the 100 lowest paid employees of the company. (Ray Bricknell, sub. 17, p. 1)
>
> … executive wages should be no more than 12 times that of the lowest paid employee. (Rodger Hills, sub. 26, p. 2)

Changes to tax arrangements

> One option that lends itself to consideration is an increase in the top marginal tax rate. … warranted by the increasing inequality in personal income, particularly between very high income earners and the rest … (David Peetz, sub. 50, p. 14)
>
> Another approach is to remove the tax deductibility of excessive remuneration paid to executives. (Australian Manufacturing Workers' Union, sub. 44, pp. 11–2)
>
> Setting a cap on executive pay is not a practicable policy solution, but, setting an acceptability cap for how much an executive can … be paid is feasible. It would remain the prerogative of the company to pay above this acceptable limit, but payments in excess of this cap could be deemed not … tax deductible. (Australia Institute, sub. DD131, p. 24)
>
> ... the Productivity Commission should not foreclose on the appropriateness of … limiting the tax deductibility of executive remuneration. … for total remuneration packages, it may well be an option that the Henry review considers (ACTU, DD trans., p. 28)

Shareholders and executives have clearly defined, and potentially different, interests concerning the distribution of company profits, but all parties — including the wider community — have an interest in wealth creation. Reforms aimed at redistributing the profit residual between shareholders and executives should avoid undermining the role of boards and jeopardising the capacity of companies to perform to their potential.

Strengthening corporate governance and board performance

Corporate governance arrangements and the role of boards are pivotal to the effectiveness of the framework for remuneration. It is important that boards are well constituted and have the right balance of responsibilities, skills and incentives to oversee the appointment and remuneration of executives in a way that best meets the interests of the company and its shareholders over time.

In an ideal world, boards would always be well up to this task. They would be contestable entities comprising a diverse range of highly competent individuals, with the skills and information at their disposal to make well-informed decisions. Directors would be free of conflicts of interest and able to resist pressures from executives who might wish to pursue their own agendas.

In the real world, directors (and executives) are fallible and boards will make mistakes or wrong judgments. The principal–agent relationships between executives and boards, and between boards and shareholders, are riddled with information asymmetries and incentive effects that can lead to executives' actions diverging from the best interests of companies and shareholders. Greater alignment can be achieved through monitoring and incentive pay structures. But these also cannot be expected to work perfectly, or without bringing costs and risks of their own.

This makes it crucial to ensure that corporate governance arrangements are well designed and function as effectively as possible. Measures, structures and practices that promote accountability and transparency create the conditions for 'disinfection by sunlight', which in turn can limit agency problems and achieve better outcomes over time.

Corporate governance in Australia today is multi-dimensional ('black letter' regulation, 'soft' law and advisory guidelines), and the product of an evolutionary process over many years. There is scope to build on this tradition to further strengthen the framework and promote a closer alignment between the interests of executives, shareholders and the boards that represent them.

Drawing on the analysis in part C of this report, the Commission has identified five areas where corporate governance could be improved further, to promote better remuneration practices.

1. **Board capacities.** The board plays the central role in determining executive remuneration. Board members need a broad mix of skills, knowledge and experience to provide independent, well-informed decision-making, including on remuneration. Board membership and renewal should reflect merit-based processes that draw appropriately from the pool of available talent.
2. **Conflicts of interest.** Given the desirability of boards operating independently, any potential conflicts of interests need to be effectively addressed. Some potential conflicts require regulatory constraints, whereas greater transparency will be sufficient in other areas.
3. **Disclosure.** Appropriate disclosure of information is necessary for shareholders to understand the extent to which their interests are being served by the company. This includes understanding executive pay structures and how pay links to company performance.
4. **Remuneration policies.** Incentive pay structures provide a key mechanism for boards to align the interests of executives with those of companies and shareholders. However, such arrangements need to be carefully designed, as inappropriately constructed pay packages can deliver perverse outcomes.
5. **Shareholder engagement.** Shareholder engagement with boards (their agents) requires appropriate signalling mechanisms and sanctions through effective voting processes and audit trails.

The Commission's Discussion Draft provided 15 preliminary recommendations across these five areas (box 11.2). Conscious that its proposals would, if implemented, have an impact on a number of related areas of corporate governance, the Commission was mindful of the potential for unforseen consequences, as well as the need to ensure proportionality among companies of widely differing sizes. The Commission therefore sought comment on its draft recommendations through submissions and public hearings, as well as other extensive consultations (see appendix A). This process elicited a substantial body of additional evidence from which this final report has drawn.

Box 11.2 **The preliminary *Discussion Draft* recommendations**

1. The *Corporations Act 2001* should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).
2. A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.
3. The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation which specifies that remuneration committees: have at least three members; be comprised of a majority of independent directors; be chaired by an independent director.
4. The *Corporations Act 2001* should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration related resolutions.
5. The *Corporations Act 2001* should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.
6. The *Corporations Act 2001* and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.
7. The *Corporations Act 2001* should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration related resolutions.
8. Section 300A of the *Corporations Act 2001* should be amended to specify that remuneration reports should additionally include: a plain English summary statement of companies' remuneration policies; actual levels of remuneration received by executives; total company shareholdings of the individuals named in the report. Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.
9. Section 300A of the *Corporations Act 2001* should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.

(Continued next page)

Box 11.2 **The preliminary *Discussion Draft* recommendations** (continued)

10. The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.

11. The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.

12. Institutional investors should disclose, at least on an annual basis, how they have voted on remuneration reports and any other remuneration-related issues. How this requirement is met should be at the discretion of institutions.

13. The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee; or seven years after the employee acquires the shares.

14. The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

15. The *Corporations Act 2001* should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why. If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re election (a 'two strikes' test) at either an extraordinary general meeting or the next annual general meeting.

11.2 Improving board capacities

Boards effectively form the bridge between management and owners. Competent and independent decision-making should be their hallmarks, requiring that directors have the appropriate mix of skills, knowledge and experience to balance effectively the remuneration of executives and the interests of shareholders. These attributes should be subject to continuous improvement, facilitated through board renewal.

Several participants contended that certain compositional and skill attributes of company boards may be impairing good decision-making (chapter 6). Primarily, concerns related to perceptions of a thin 'gene pool' of company directors, reflecting a ‘directors’ club’, which recruits from within itself and the ranks of known senior executives. In turn, this was said to lead to boards identifying too closely with executives in deliberations about executive pay, and directors spreading themselves too thinly across multiple appointments.

It is also important to recognise that, given the importance of boards working together cooperatively, informal selection processes based on ‘known quantities’ can have beneficial effects, provided this does not perpetuate values that are contrary to the best interests of shareholders or the wider community.

Evidence of directors having extensive multiple appointments (‘over-boarding’) among the larger public companies is lacking (chapter 6). In any event, because multiple directorships can deliver synergistic and networking benefits, the point at which these may become excessive or problematic would seem best left to boards, the individual directors themselves — who face positional liability from poor decision-making — and shareholders.

As to diversity within boards, the evidence supports that many non-executive directors are drawn from the ranks of senior executives — for example, in 2000, about 35 per cent of non-executive directors were retired CEOs (chapter 6). A further revealing statistic is that women constitute just over 8 per cent of directors of ASX200 companies. Their under-representation on boards appears to be even greater than the already low female representation in the key ‘feeder group’ of senior executives. This pronounced gender imbalance has persisted — indeed, has actually worsened — despite the existence of more highly qualified women, and suggests that boards are not drawing sufficiently widely from the talent pool.

Uncertainties about the evidence, coupled with the downside risks from absolute restrictions — such as caps on the number of board appointments that can be held or on non-executive appointees, or instituting binding quotas for women — mean resort to such measures would be imprudent. Mandatory conditions also weaken the rights of shareholders to choose the directors who will be accountable to them.

However, it is in the interests of shareholders that any unwarranted barriers to board diversity and renewal be addressed. The key areas raised are the apparent obstacles facing women candidates — a proxy for diversity more generally — and the so-called ‘no vacancy’ rule that impedes non-board endorsed individuals from contesting board elections.

Impediments to board diversity — gender balance

Improving gender balance would appear an evident starting point to encourage boards and their nomination committees to better access the diverse talent pool for future directors. Outcomes to date suggest that significant progress is unlikely to be made unless companies are required to report against measurable benchmarks for achieving greater diversity. Voluntary board-endorsed goals are more likely to promote access to skills and diversity without the downsides of being seen as 'tokenism', or subjugation of the merit principle (chapter 6).

It is therefore a welcome development that the ASX Corporate Governance Council is proposing to require listed companies to adopt and disclose a diversity policy that includes measurable objectives relating to gender, on an 'if not, why not' basis. The Council further proposes that nomination committees include in their charters a requirement to review the proportion of women at all levels in their companies. It expects to provide an exposure draft for public consultation in early 2010, with an anticipated implementation date of 1 July 2010.

The Commission supports the Council's proposals to apply pressure on boards through self-regulation and transparency. However, outcomes will need to be monitored and evaluated and, depending on progress, the scope for stronger action should be considered. A review of the impact of the initial requirements should be conducted three years after their commencement.

FINDING 1

The continuing marked under-representation of women on boards indicates that boards are not drawing sufficiently widely from available talent. Given the lack of progress in addressing this, the Commission strongly endorses the initiatives by the ASX Corporate Governance Council:

- *to require companies to adopt and disclose, on an 'if not, why not' basis, their progress against gender objectives set by their boards*
- *to encourage nomination committees to review the proportion of women at all levels in the company and disclose annually the skills and diversity criteria used for board appointments.*

Outcomes should be reviewed three years after the measures have been introduced, including to determine whether the principles and recommendations should be upgraded to a listing rule by the Australian Securities Exchange.

Impediments to board renewal — the ‘no vacancy rule’

The ‘no vacancy rule’ refers to a practice adopted by some boards — and permitted under most companies’ constitutions — to set the number of directors at *a given time*, within the company’s constitution (for example, at six members out of a possible nine). This practice can impede the election of new board members. In essence, if no vacancies are declared, candidates without board endorsement need to receive not only a majority of the votes cast on their election, but also more votes than a board-endorsed candidate seeking (re-)election. If vacancies exist, only the first condition need be met (see chapter 6).

Not all boards invoke this provision and, for those that do, the objective may be to deter election of candidates who would be inappropriate or destabilising influences. A board that does not function well is likely to be associated with poor decision-making and not serve well the interests of shareholders.

However, some participants argued that the practice merely serves to entrench a ‘closed shop’ for directorships. Clearly board numbers must have majority support of shareholders and the constitutional limit on board membership is a matter for shareholders. But whether such ‘shareholder democracy’ should extend to direct input on a board’s size at a given time is less clear. Boards are likely to be better situated to assess optimum operational and compositional requirements, depending on the circumstances of companies in particular periods.

This is complicated further by uncertainty about the practical consequences of removing the ‘no vacancy rule’. If the positive imprimatur conferred on board-endorsed candidates were influential, especially for institutional investors, non-endorsed candidates would find election difficult. Alternatively, if non-endorsed candidates were elected, board numbers could tend to the maximum. To pre-empt this, boards might seek to put forward more endorsed candidates, also leading to bigger boards, or seek shareholder approval to reduce the maximum board size.

Neither outcome would seem desirable. Bigger boards are unlikely to promote better decision-making and reducing board size would reduce a board’s flexibility to secure the services of well qualified candidates who become available, or to fill a vacant position that reflects an emerging need — for example, a board member with particular expertise following an expansion into a new market. Responses to the Commission’s draft recommendation 1 (box 11.2) shed little light on how to balance these competing claims.

The Commission is mindful of the costs associated with unwieldy boards and reduced flexibility, but acknowledges the perceptions that the ‘no vacancy rule’ is being misused and that the power to vote for and against directors — the ultimate sanction available to shareholders — should not be circumscribed unduly. Of course, shareholders could take direct action on the 'no vacancy' practice by putting forward a special resolution, but the transactions costs of this approach are likely to be high, particularly as it could involve mobilising dispersed retail shareholders.

In this light, the Commission considers that it would be appropriate for those boards that wish to invoke the 'no vacancy rule' in relation to the election of directors to explain the reasons why, and seek shareholder approval for the practice by way of an ordinary resolution. If that resolution were rejected, vacancies would be declared to the maximum in the company's constitution for that annual general meeting. The board should still retain the right to appoint a director at any time throughout the year (subject to the usual confirmation at the next annual general meeting) and to fill, or leave vacant, casual vacancies as required.

Removing automatic 'no vacancy' provisions might be expected to encourage more nominations, including potentially 'vexatious' ones. Company constitutions have varying requirements for board nomination that could deal with this.

RECOMMENDATION 1

For the election of directors at a general meeting, where the board seeks to declare no vacancies and the number of directors is less than the constitutional maximum, approval should be sought from shareholders by way of an ordinary resolution at that general meeting.

Boards would retain their powers to appoint directors and fill or leave vacant casual vacancies throughout the year.

This recommendation should be effected through amendments to the Corporations Act 2001 and relevant regulations.

11.3 Reducing conflicts of interest

Avoiding potential conflicts of interest is an important consideration for many organisational forms and boards are no exception. Conflicts of interests are particularly likely to emerge in relation to remuneration matters. They need to be managed effectively.

Remuneration committee membership

Remuneration committees allow for specialisation in setting executive remuneration and address the conflict of interest that can arise where executive directors are able to directly influence decisions on their own pay. But while remuneration committees place remuneration matters at arm's length from management, this objective can be compromised if CEOs and/or executive directors participate in those committees or are present when decisions are made about their remuneration.

The ASX Corporate Governance Council recommends that boards establish remuneration committees (an 'if not, why not' requirement). It also *suggests* — but does not formally recommend — that remuneration committees consist of a majority of independent directors, that they be chaired by an independent director and have at least three members.

The basis for the Council's position is sound, but in the Commission's view, its status as a 'suggestion' provides an insufficient influence on companies. Only around three-quarters of the top 250 companies and about half of mid-cap companies have at least a majority of independent directors on their remuneration committees (chapter 6).

The Commission considers that the Corporate Governance Council's suggestion on the composition of remuneration committees should be upgraded to an 'if not, why not' recommendation, with the important additional condition that there be no executives on remuneration committees. The Commission further considers that the Corporate Governance Council's suggestion that remuneration committees should have a charter that clearly sets out 'the procedures for non-committee members to attend meetings' should be similarly upgraded.

These changes would send a necessary signal to all listed companies about the conflict of interest inherent in executives influencing pay decisions through both direct and indirect participation in remuneration committees. However, the latitude in an 'if not, why not' requirement makes allowance for the practical limitations facing smaller companies.

RECOMMENDATION 2

The ASX Corporate Governance Council should introduce an 'if not, why not' recommendation specifying that remuneration committees:

- ***have at least three members***
- ***comprise non-executive directors, a majority of whom are independent***
- ***be chaired by an independent director***
- ***have a charter setting out procedures for non-committee members attending meetings.***

Best practice remuneration processes are more important for large companies. They also are more able to meet the costs entailed. Accordingly, the Commission considers that for large companies — in addition to satisfying the 'if not, why not' requirements — it should be *mandatory* that no executives serve on remuneration committees. This would be consistent with the course pursued by the Australian Prudential Regulation Authority for the financial sector. APRA is requiring that a majority of members of the remuneration committee be 'independent' and that the committee comprise solely non-executive directors (chapter 5).

In its Discussion Draft, the Commission proposed a similar course of action as APRA for ASX300 companies (draft recommendation 2, box 11.2). However, it accepts that such a proposal would, in this broader context, be problematic because it injects into 'black letter' law the current relationship-based definition of 'independent'. A listing rule that indirectly mandated a minimum number of directors who did not have a substantial shareholding or association with a substantial shareholder — a current criterion for 'independence' — could be difficult even for some ASX300 companies to achieve (chapter 6).

Taking these considerations into account, the Commission considers that a new listing rule be confined to the matter of executives being on remuneration committees, rather than seek to define the composition of those committees. The latter is best achieved through the 'if not, why not' approach in recommendation 2, which would apply to all listed companies.

RECOMMENDATION 3

In conjunction with recommendation 2, a new ASX listing rule should specify that all ASX300 companies have a remuneration committee and that it should comprise solely non-executive directors.

Confining 'black letter' law to a subset of companies that can move in and out of arbitrary thresholds already has been accommodated in ASX listing rule 12.7 (pertaining to audit committees) which specifies that, if a company was within the ASX300 at the beginning of a financial year, it must comply with the ASX Corporate Governance Council's recommendation on the composition of the audit committee.

Directors and executives voting on remuneration reports

The primary purpose of the non-binding vote on the remuneration report is to allow shareholders to convey a signal to the board about a company's remuneration practices. All shareholders in a company are able to vote on the remuneration report, including shareholders who are also directors or executives. There will be instances where the shareholdings of directors and executives are likely to be large enough to make a significant difference to the outcome of the vote.

It could be argued that not allowing directors and executives to vote would deny them a right that exists for other shareholders. However, current laws already preclude directors voting on remuneration matters where a conflict of interest can arise. Extending this voting prohibition to directors and key management personnel to ensure the 'purity' of the shareholder signal in the special case of the non-binding vote on remuneration reports is appropriate. The purpose of the non-binding vote is to give non-involved shareholders a say and it is incongruous for directors and executives to be able to influence this outcome.

Extending this prohibition to the 'associates' of directors and key management personnel appears infeasible in practice. As many participants indicated, the term 'associates' could inadvertently preclude from voting some major company shareholders by virtue of them being defined as associates to the primary company. Even a tighter definition such as 'close associate' — defined in s. 9 of the Corporations Act — could inappropriately exclude relatives of directors or key management personnel who independently purchased shares in the company.

RECOMMENDATION 4

The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors be prohibited from voting their shares on remuneration reports and any resolutions related to those reports.

Hedging equity remuneration

Performance-based pay structures are expressly designed to expose executives to company-specific risk in order to concentrate their efforts on driving performance. Hedging incentive payments can allow executives to effectively transform 'at risk' pay to fixed pay, undermining the intent of their contracts (chapter 7). Shareholder confidence in remuneration practices would be strengthened if the potential for a misalignment of interests between companies and executives were reduced.

RECOMMENDATION 5

The Corporations Act 2001 should specify that companies prohibit their executives from hedging unvested equity remuneration or vested equity subject to holding locks.

Undirected proxies

When shareholders provide directed proxies, they specify their voting instructions to their proxy holder. The chair of the meeting is normally the default proxy choice — that is, if shareholders do not appoint a proxy, the proxy defaults to the chair. Chairs must vote all their directed proxies, but other proxy holders are under no obligation to do so.

Where voting instructions are not specified, the proxy is 'undirected', which gives the proxy holder discretion to determine how to vote. Chairs can exercise their undirected proxies at their discretion, even on resolutions where they are otherwise prohibited from voting — for example, approving an increase in the director fee pool. Given that concerns about conflicts of interest have resulted in directors being prohibited from voting on certain resolutions, it seems contradictory to then allow the chair to vote undirected proxies on those same resolutions.

However, boards generally state their voting recommendations on the proxy form Where proxies are undirected, the presumption is that shareholders have made a considered decision to follow the board's view on resolutions, rather than abstain from voting. Many participants considered that prohibiting proxy votes from being counted would disenfranchise those shareholders, who wish to rely on others' judgment rather than submit a poorly considered directed proxy.

One way of ensuring a more informed vote would be to require the board's position and any potential conflicts of interest to be made explicit. For example, ASX listing rule 14.2.3 could be extended to voting on remuneration reports — that is, proxy forms would note that the chair was excluded from voting his or her own shares but would vote undirected proxies in a specified way (chapter 9). Nevertheless, in relation to the special case of the non-binding vote on remuneration reports, it seems inappropriate that executives and directors engaged in the design of remuneration arrangements should then be able to use undirected proxies to mute the outcome of that vote. For similar reasoning to that behind recommendation 4, the Commission considers that governance arrangements would be improved if directors and executives were not able to employ undirected proxies in this instance.

RECOMMENDATION 6

The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors from voting undirected proxies on remuneration reports and any resolutions related to those reports.

‘Cherry picking’ votes

Non-chair proxies are not obliged to exercise all their directed proxies and can vote shares that support their view on a resolution, while ignoring other directed proxies. Such ‘cherry picking’ lacks transparency and reduces the effectiveness of shareholder voting (chapter 9).

Under a proposed amendment in the Corporations Amendment Bill (No. 2) 2006, which has not yet been placed before Parliament, non-chair proxy holders would not be obliged to cast their proxies, but if they cast any proxies, would be required to cast them all. This would end ‘cherry picking’, but not entirely remove the conflict of interest for non-chair proxy holders — if proxy holders received a large number of proxies that did not support their view, they could still choose not to vote any.

The Corporations Amendment Bill (No. 2) 2006 recognises that forcing proxy holders to vote all their proxies could be problematic. A proxy holder may unknowingly be appointed as a proxy and there could be legitimate reasons why a proxy holder was unable to attend a meeting or vote on a poll. The Commission does not find these arguments compelling. Where a non-chair proxy holder does not attend the meeting, the proxy generally defaults to the chair, who is required to exercise the directed proxies. Provision could be made to ensure that proxy holders were not subject to sanction where they had not consented to, or were unaware of, their appointment.

RECOMMENDATION 7

The Corporations Act 2001 should be amended to require proxy holders, except in exceptional circumstances, to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.

(The Commission sees merit in this recommendation applying to other resolutions.)

11.4 Improving relevant disclosure

A company’s remuneration report is the key source of information for shareholders on how executive remuneration is determined and the philosophy or strategic purpose behind it.

The remuneration report

Remuneration reports have tended to become ‘boiler-plated’ to meet statutory requirements. They are also proving impenetrable for many retail investors and potentially misleading to lay readers (chapter 8). Moreover, information likely to be of most use to shareholders is often absent or deficient; notably:

- discussion of remuneration policy and the links between remuneration and performance is often cursory at best
- pay as *actually realised* by executives is not required to be reported
- short-term performance hurdles are rarely disclosed adequately.

Plain English summaries of remuneration policy and approach

A company's remuneration policy ideally should provide information on how remuneration of key management personnel is determined and the philosophy behind that approach. In addition, it should indicate the company's broader approach to performance and strategy, including a discussion of the approach to remuneration-setting and the variables and risks considered.

There are many examples of remuneration reports for which companies have included 'plain English' summaries outlining their pay philosophy and rationales for using particular pay instruments. These demonstrate that there is no real impediment to companies providing informative, 'shareholder-friendly' remuneration reports. To help companies improve their reports, there could be merit in representative (including investor) bodies developing a best practice guide. (The Securities and Exchange Commission produces a plain English handbook for companies in the United States.) In addition, or as an alternative, company reports that clearly convey information to investors could be identified and publicised as best practice.

The Commission considers that a regulatory requirement for plain English explanations could be a useful signal, even if difficult to enforce. Ultimately, such a signal — particularly in tandem with stronger consequences from the vote on remuneration reports (see below) — could empower shareholders to demand relevant and comprehensible information, and encourage companies to provide it.

Actual pay

Reported equity-based remuneration reflects estimated accounting costs to the company, not the value of the equity the executive receives. That reported equity based pay does not equate to actual remuneration is not well understood by many shareholders, and has often led to a confused public debate. Retail investors and the community are likely to be more interested in the actual remuneration received by the executive (and paid by the company). Proxy advisers, governance groups and institutional investors are likely to be interested in the estimated value of incentives at grant as well as what the executive eventually receives based on performance.

Including both sets of information would add to the information burden in the remuneration report, but this seems justifiable if shareholders (and the community) are to understand a company's remuneration policies and the relationship to company performance. One simplification measure would be to confine the detail of valuation methodologies for equity rights to the financial statements, while retaining disclosure of the actual value for each executive in the remuneration report. (How this is best achieved is discussed in chapter 8.) There also seems to be a case for estimated values of long-term incentives to reflect their (total) fair value at grant, rather than the amortised annual accounting value, which adds yet another source of confusion.

Performance hurdles

In relation to disclosure of performance hurdles, the Corporations Act only requires disclosure of a 'detailed summary of the performance condition', not the specifics. Most large companies appear to report hurdles for long term incentives (which typically are linked to publicly-available performance measures). However, they provide little, if any, information about short-term incentive hurdles, which are more likely to relate to internal and, therefore, commercially sensitive, indicators.

While the Commission does not see a case for strengthening legislation in this area, there would appear to be ample scope for companies to provide discussion about the broad nature of short-term hurdles without compromising commercially sensitive information.

Executives' shareholdings

One important indicator of alignment between the actions of executives and company performance is the extent of their wealth that is linked to the company's fortunes. Potential and actual changes in wealth can obviously have a significant effect on executives' behaviour.

As changes in the value of an executive's portfolio are not 'remuneration', there is no requirement for remuneration reports to include company shareholdings for the individuals named in the report. (However, a company's financial statements must report equity and exercised options or rights, and similar information for directors forms part of the annual directors' report.)

Having this information summarised in the remuneration report would provide a more complete picture of the extent to which an executive's incentives were aligned with the interests of the company and shareholders. While it would add somewhat to the volume of remuneration reports, some companies already do this of their own accord.

RECOMMENDATION 8

The usefulness of remuneration reports to investors has been diminished by their complexity and by crucial omissions. Remuneration reports should include:

- ***a plain English summary statement of companies' remuneration policies***
- ***actual levels of remuneration received by the individuals named in the report***
- ***total company shareholdings of the individuals named in the report.***

The Australian Government should establish an expert panel under the auspices of the Australian Securities and Investments Commission to advise it on how best to revise the architecture of section 300A of the Corporations Act 2001 and the relevant regulations to support these changes.

The convened expert panel should take account of the Commission's:

- detailed guidance on the requirements for recommendation 8 (see chapter 8)
- 'check list' of information which should, where relevant, be reflected in remuneration reports (section 11.5).

Coverage of management personnel

The remuneration report discloses the pay of specified individuals. Disclosure of remuneration of the five most highly paid executives was introduced in 1998, with 'key management personnel' added in 2004, in tandem with the introduction of the remuneration report. The concept of key management personnel conforms to the Australian Accounting Standards Board standard 124.

Essentially, the reference to the five highest paid executives is a legacy of regulatory changes that occurred when there was no coherent interaction between the Corporations Act and Australian Accounting Standards. Its contemporary usefulness is questionable.

The remuneration report should appropriately focus on those individuals who may be able to influence their own pay or materially affect the management of the company. Restricting disclosure to key management personnel would be consistent with this. Even then, some remuneration reports would likely continue to cover ten or more individuals. Many participants signalled little interest in remuneration details beyond the CEO.

Rationalisation of coverage would likely have a negligible effect on large companies, where the five highest paid group and company executives are likely also to be key management personnel. Conversely, small companies may have fewer than five key management personnel, in which case there could be some reduction in disclosure. However, the executives removed from the remuneration report would, by definition, not have responsibility for managing or controlling company activities.

RECOMMENDATION 9

Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to key management personnel. The additional requirement for the disclosure of the top five executives should be removed.

External advice on remuneration

Remuneration consultants provide market data and insights on remuneration trends. They also advise boards and remuneration committees on matters relating to pay structures and performance hurdles. Some companies specialise in providing advice solely to boards; others provide consulting services to management as well.

A potential conflict of interest clearly arises where senior executives appoint remuneration consultants to provide advice to boards on their pay. That said, it is appropriate for remuneration consultants to be able to consult with executives when framing their advice — interaction with management could be expected to lead to more relevant and informed remuneration advice (chapter 6).

Conflicts of interest can also arise where a consultant is providing remuneration advice to the board as well as other services to management. The consultant may naturally feel that remuneration advice unfavourable to executives may compromise access to other, often more lucrative, work.

Generally, companies and remuneration consultants are mindful of the potential for such conflicts and employ a number of strategies, including:

- companies requiring that remuneration committees or boards contract the consultant directly
- companies limiting other services they receive from the consultant

- consultants providing remuneration advice to boards or management, but not both
- consultants developing in-house policies such as ‘Chinese walls’ and internal third-party scrutiny.

Companies are not required to disclose their use of remuneration consultants, though some do so voluntarily. Greater disclosure about the use of remuneration consultants would give shareholders useful knowledge about the nature of contractual arrangements entered into by the board or remuneration committee.

For the financial sector APRA has announced that, if a remuneration committee (or the board) makes use of expert advisers, they should have the power to do so in a manner that ensures that the engagement, including any advice received, is independent. APRA’s prudential guide further notes that remuneration committees should not engage advisers who are acting concurrently or have acted recently on behalf of management or of any executive of the regulated institution. These matters will be compulsory for APRA-regulated entities and could be applied more widely to listed companies through ASX listing rules.

An alternative to the mandatory route would be to pursue greater disclosure from listed companies on an ‘if not, why not’ basis. This would be better suited to dealing with the diversity of listed companies but would require an ASX Corporate Governance Council recommendation. (Any disclosure requirements should take into account that boards might not have accepted or followed the advice of the remuneration consultant.)

The Commission sees merit in graduated approaches and accordingly made two draft recommendations to this effect — an ‘if not, why not’ recommendation for all companies (draft recommendation 11, see box 11.2) and a listing rule requirement for large companies (draft recommendation 10, see box 11.2).

The two entities with responsibility for the derivation and implementation of these draft recommendations — the Australian Securities Exchange (draft recommendation 10) and the ASX Corporate Governance Council (draft recommendation 11), while supportive of their intent, expressed a preference for all of the matters to be incorporated into a single Corporate Governance Council ‘if not, why not’ requirement. They contended that this would ensure better integration and consistency and avoid the drafting complexities associated with ensuring that ‘black letter’ law accords with intent.

Other participants also argued that, if implemented, draft recommendation 10 would lead companies to avoid using expert advisers, drawing instead on management input. On this, the Commission considers that introducing a disclosure requirement (an inadvertent omission in draft recommendation 10) would make this unlikely.

The Commission considers that the potential for conflicts where senior executives appoint remuneration consultants to advise boards on their pay is sufficient to warrant the application of a listing rule for larger companies.

RECOMMENDATION 10

The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.

RECOMMENDATION 11

The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.

Disclosure of voting by institutions

Institutional investors are specialised financial institutions that manage the collective savings of small investors, with the aim of achieving particular risk, return and maturity objectives. They include superannuation (pension) funds, life insurance companies, and investment companies, such as mutual funds (chapter 2).

While institutional investors have a fiduciary duty to act in the best interests of their members, fund managers may not have incentives that completely align their interests with those of their members, giving rise to the need for monitoring Moreover, Australia's compulsory superannuation system in concert with the use of equities as an investment tool by superannuation funds means that sharemarket performance is important for a significant proportion of the population. In this environment, principal–agent issues from information asymmetries can emerge.

There is no requirement for shareholders, including institutional investors, to vote their shares. Investors assess the merits of analysing the information required to make an informed vote and, where they choose not to, this could reflect a rational decision on their part. Compulsory voting would increase voting rates, but also lead to more ‘donkey’ voting and more proxies. It could also lead to institutions relying more on proxy advisers, rather than applying their own analysis.

Requiring institutional investors to disclose whether and how they voted, on the other hand, could provide a greater incentive for them to vote, but still enable them to abstain from doing so where they did not consider it cost-effective or in their members’ interests. The likely consequential increase in voting, would be consistent with the fiduciary duty of institutional investors to their members.

Voting disclosure might also lead to more informed (potential) investors. This could influence their decisions about which fund they wished to invest in. Since it would be detrimental to an institution’s reputation to be seen to have voted the ‘wrong’ way (or not voted at all) on a particular issue, this could encourage better communication about the basis for a voting decision.

Some participants argued against disclosure of voting records on the basis that it could inhibit, rather than encourage, voting if institutional investors wished to avoid public conflict or the need to articulate why they had voted against board-supported resolutions. However, institutions that currently disclose their voting records, often vote against board recommendations, including remuneration reports (chapter 9).

The primary disadvantage of voting disclosure would be the compliance burden for institutional investors, who potentially could vote on many resolutions across hundreds of companies. This could be mitigated by confining disclosure to key resolutions — such as remuneration reports, remuneration-related issues and possibly election of directors — with reporting on the institution’s website.

This matter is likely to be best addressed by institutions and industry associations themselves. For example, the Investment and Financial Services Association has a standard in place that addresses disclosure of voting by institutional investors. In relation to superannuation, where substantial funds under management are contributed on a compulsory basis, the case for exerting some leverage to progress disclosure of voting may be warranted.

RECOMMENDATION 12

Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to superannuation funds regulated under the Superannuation Industry (Supervision) Act 1993.

11.5 Well-conceived remuneration policies

A 'check list' for boards

Linking executive pay to performance is desirable to achieve greater alignment between the interests of executives and shareholders. Moving from principle to practice opens up possibilities for design error. The more complex the pay instrument, the greater the possibility that perverse outcomes could arise. Equity- and options-based remuneration can be complex, with different forms having different incentive effects. Some equity instruments will suit particular types of companies, market circumstances and individuals better than others (chapter 7). Boards generally are motivated to structure remuneration packages in a way that limits harmful risk taking. This might be achieved by a mix of short- and long-term incentives, and through the deferral of payments to enable performance to be validated over time.

Larger companies tend to provide executives with a mix of base pay and short- and long-term incentive payments subject to performance hurdles. Hurdles for short-term incentives are generally directed at outcomes over which individual executives have direct influence. Hurdles for long-term incentives can be affected by a wide range of factors, and consequently can be heavily discounted by executives. However, long-term incentives are generally more transparent and often perceived to be more closely aligned with shareholders' interests, and for that reason favoured by many. But given the diversity of companies, and the changes that occur within and across them over time, a 'one size fits all' approach is unlikely to be effective. Board discretion will always be important to ensure that pay structures are appropriate to a company's circumstances.

The evidence of the link between long term incentive-based pay and performance is mixed and many companies are continuing to refine incentive payment structures. However, in some instances, pay structures appear to be more a reflection of companies 'matching the market' than being designed to best fit the strategic needs of the company. Some remuneration consultants contended that some companies devote insufficient attention to aligning company goals within an overarching and complementary pay philosophy.

That some boards manage remuneration structures better than others does not lead to any particular policy prescription. That said, given the inherent difficulties with specifying performance hurdles, particularly in the relatively thin Australian market, some boards may need to devote more attention to the tradeoffs associated with highly complex equity-based instruments. Attempting to incentivise multiple areas of an executive's behaviour simultaneously with different pay instruments is challenging and increases the risk of perverse consequences — whereas a simple tool, like equity with holding locks, may achieve considerable alignment simply by keeping 'skin in the game'.

Many boards appear to be responding to the challenges of aligning executives' and shareholders' interests through modifications to pay structures, but they may not always be communicating their thinking adequately to shareholders. Even well-conceived remuneration packages can become contentious if rationales are unclear. A lack of transparency and understanding can reduce investor confidence. Remuneration reports — and in particular, the Commission's recommendation for these to include plain English policy summaries — provide an opportunity to improve transparency and promote understanding.

To this end, the Commission has identified a 'check list' that boards could usefully consider. While the content will be familiar to most boards, much of it relates to matters that shareholders (and the wider community) would find highly informative and which should be addressed in remuneration reports.

FINDING 2

Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, some key dimensions often warrant being explained clearly to shareholders and, where appropriate, could usefully be addressed in companies' treatment of their remuneration policies in the remuneration report:

- *how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests*
- *how the mix of base pay and incentives relates to the remuneration policy*
- *how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected, and how such benchmarks have been applied*
- *how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price), and how any deferral principles and forfeiture conditions would operate*
- *whether any 'incentive-compatible' constraints or caps apply to guard against extreme outcomes from formula-based contractual obligations*
- *whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)*

- *whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order to avoid litigation*
- *whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.*

Addressing impediments to alignment of remuneration structures

Corporate governance principles generally acknowledge the importance of aligning executive pay with long-term shareholder value. Internationally, this has been emphasised by the Financial Stability Board and the G-20. In Australia, APRA (and many company boards) consider that deferral periods of equity-related remuneration components can ensure that executives maintain a long-term view. Lagging a component of an executive's remuneration — particularly for a CEO, who can have a material impact on a company's fortunes especially when nearing the end of tenure — would enable longer term legacy impacts to be taken into account.

However, the requirement that employees pay income tax on equity-based instruments at termination of employment creates a significant disincentive for executives to have such arrangements. Accordingly, adoption of this alignment mechanism is inhibited. (It appears that one or two companies have been able to get around this, but at some cost.) The tax integrity issues that have been advanced in support of retaining termination of employment as the taxing point for equity-based payments would not appear insurmountable (chapter 10).

While lengthy deferral periods for equity-related remuneration may not always be appropriate, current tax arrangements constrain boards from devising such strategies. Although there may be some costs to revenue from extension of tax deferral beyond termination, the Commission considers that the broader economic costs of not changing this provision are more significant for policy. Moving the taxation point from the cessation of employment to realisation of the asset would address this effectively. (This could be equivalent to the taxing point being at the Employee Share Scheme deferred taxing point in division 83A, *Income Tax Assessment Act 1997*.)

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.

11.6 Facilitating shareholder engagement

Shareholders have the power to elect boards and to vote on matters where their interests potentially might not align with those of directors and executives — typically remuneration-related matters. For example, the Australian Government introduced legislation to reduce the trigger for a binding vote on termination payments. (This may have relatively benign effects, because termination payments are occasional and the one-year base pay threshold now accords with established practice for the majority of companies.) That said, voting is not generally intended to be a means for shareholders to intrude directly into a company's operations (chapter 9). Consistent with this, shareholders have an 'advisory' vote on a company's remuneration report.

Voting is the primary means by which boards are made accountable to shareholders, although its efficacy in practice will depend on the extent to which shareholders choose to exercise their rights and the integrity of the voting system.

Improving the integrity of the voting system

The shareholder voting system is central to board accountability and shareholder engagement. Shareholders should have confidence that votes in absentia are cast as instructed. However, processing votes via a paper-based system is outdated and prone to error — proxy votes go missing and there is a lack of an audit trail (chapter 9).

Electronic voting for proxies would remove most of the downsides of the paper-based system, such as lost votes, illegible proxy forms and processing error. An electronic system would also facilitate the introduction of a full audit trail, which would give further confidence about the results of contentious or close voting results.

More generally, electronic voting would facilitate the introduction of direct voting, bypassing the need for, and the flaws associated with, proxy voting. The cost of implementing and operating electronic voting is unlikely to be prohibitive, given the cost to companies from mailing and processing the paper-based vote.

There are no practical impediments to companies adopting electronic voting, but there has been uncertainty about its legality in light of extant company constitutions. However, a Parliamentary Joint Committee on Corporations and Financial Services considered that, because the Corporations Act does not explicitly require a company to offer electronic voting, there may be some uncertainty as to whether a company is permitted to use electronic voting where this is not provided for in its constitution.

In the Discussion Draft the Commission made a draft recommendation that this situation be clarified by the Australian Securities and Investments Commission (ASIC) (draft recommendation 14, see box 11.2). In its response, ASIC contended that the electronic appointment and authorisation of proxies is permitted under the Corporations Act and 'in most cases can be implemented without a company needing to change its constitution' (chapter 9). Since this position remains somewhat equivocal, the Commission has retained its recommendation.

RECOMMENDATION 14

The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

Consequences of a significant 'no' vote on the remuneration report

Voting on the remuneration report provides shareholders with an opportunity to signal whether they support a company's remuneration policy. Being advisory and non-binding, it enables them to influence executive pay policy and outcomes without curtailing the board's operational role.

Most participants submitted that the non-binding vote has been effective in improving engagement, citing instances where remuneration arrangements have been amended in anticipation of, or in response to, significant 'no' votes. Notable examples include Telstra, which in 2007 received a majority vote against its remuneration report, leading it to engage with its shareholders and to change its pay practices. Its 2008 report received resounding approval. Similarly, in 2008, Boral received a 58 per cent 'no' vote against its remuneration report, followed by 93 per cent approval of its next report, which set out the steps taken to address shareholder concerns (chapter 9).

But while the evidence suggests that boards are generally responsive to ‘no’ votes, this is not universal. Anecdotal and other evidence points to some companies being unresponsive to even significant ‘no’ votes. The Commission found that nearly 5 per cent of ASX200 companies have received consecutive ‘no’ votes of 25 per cent or more and the incidence of this appears to have been rising in recent years. This includes a few cases of substantial consecutive ‘no’ votes. For instance, Transurban received a 59 per cent ‘no’ vote on its 2008 remuneration report and a 47 per cent ‘no’ vote the following year and St Barbara received consecutive ‘no’ votes of 61 per cent and 58 per cent (chapter 9). The Commission considers that there is a case for boards of such companies to face further consequences where shareholders consider that they have not responded adequately to concerns raised the previous year.

The ‘two strikes’ proposal

The challenge is to provide a mechanism for shareholders to deal with the relatively small proportion of companies that appear unresponsive to their concerns, without impacting adversely on the majority of companies (and their shareholders) for whom the current arrangements appear to be working. In seeking to address this, the Commission proposed a ‘two strikes’ mechanism in its Discussion Draft to target unresponsive boards (draft recommendation 15, see box 11.2). This contained the following key features:

- where a company’s remuneration report received a ‘no’ vote of 25 per cent or more, the board would be required in the subsequent remuneration report to explain how shareholder concerns were addressed (the ‘first strike’)
- where a company’s subsequent remuneration report also received a significant ‘no’ vote, all elected board members would be obliged to stand for re election (the ‘second strike’).

Acknowledging that the second strike involved a stronger sanction than the first, with greater potential for costs and disruption, the Commission left open for further consideration the question of the appropriate threshold for its attainment.

Participants’ responses

Most participants favoured the first strike part of the draft recommendation, seeing it as a means of enforcing what was generally regarded as a desirable practice.

Those who opposed it, typically did so on the basis that it was the precursor to a stronger sanction to which they were opposed.

There was strong support for the second strike among shareholder groups, advisers to superannuation funds, unions and individuals. Some others, including governance advisors, supported the proposal in principle, provided that there was a majority voting threshold or trigger for the second strike.

Many participants, however, regarded the second strike as unnecessary, citing the perceived effectiveness of the non-binding vote in improving board–shareholder engagement, and the fact that shareholders already have certain remedies at their disposal to sanction recalcitrant companies — through the normal board re-election process and the ability for shareholders with five per cent or more of issued shares to put a special resolution, including for the removal of directors (box 11.3 and chapter 9).

Box 11.3 **Existing sanctions available to shareholders**

Shareholders can signal dissatisfaction with a board by:

- voting against one or all of the one-third of the board required to stand for re-election at each annual general meeting. Over a 12 month period, protest votes could be directed at two-thirds of the board. However, directors generally have been re-elected with a high proportion of the vote even following sizeable ‘no‘ votes on remuneration reports.
- putting a resolution to remove a director (or directors). This requires the support of 5 per cent or more of issued shares or 100 shareholders. The Commission is not aware of any instances where shareholders have removed, or sought to remove, directors under this provision due to dissatisfaction with remuneration outcomes.

Moreover, company representatives, as well as advisers to companies and institutional shareholders, considered that the second strike would have significant downside risks (chapter 9). Chief among the concerns were that it could:

- conflate the advisory signal on remuneration with the prospect of spilling the board, thereby deterring some investors from expressing dissatisfaction with the remuneration report
- lead boards to take the line of least resistance and adopt generic (‘vanilla’) pay practices likely to be acceptable to proxy advisers and others, rather than seek to devise innovative pay structures that better met the specific needs of the company

- lead to some directors choosing not to recontest their positions if forced to present themselves for re-election over perceived failures on remuneration matters
- provide a ready vehicle for shareholders to pursue objectives or agendas unrelated to remuneration (for example, takeovers without having to declare intent).

A range of other concerns were contingent on the threshold trigger and on other aspects of how draft recommendation 15 would operate in practice (table 11.1). A key consideration was that a board re-election prompted by a minority vote would involve costs but serve little purpose, if the majority who endorsed the remuneration report voted similarly (or, as is common, more favourably) on the re-election of directors.

Table 11.1 **Summary of matters for 'second strike' consideration**

Issue	*Options*
The threshold trigger	Should the trigger be a minority (25 per cent) or consistent with the majority for re-election of directors (>50 per cent)?
Which votes?	With the median percentage of votes cast in a top 200 company currently being around 54 per cent, a 25 per cent 'no vote' could be carried by under 14 per cent of votes on issue (chapter 9). Accordingly, should voting be based on votes cast (normal resolutions) or shares on issue (the 5 per cent resolution rule).
The subject of the sanction	Who should be subject to sanction — the chair of the remuneration committee, the chair of the board, all board members, all elected board members? What of directors not involved in the previous one or two remuneration reports?
Timing of an election	Should the director election occur at the next AGM (up to 12 month delay) or sooner?
What next?	If the second-strike is reached, but the board is not spilled, does a 're-set' occur or is a first strike deemed to have occurred?

The Commission's assessment

The Commission has given careful consideration to the various issues raised by participants and made some significant changes to the design of the scheme it is finally recommending to Government.

In defence of the 'two strikes' approach itself, the Commission accepts that alternative voting mechanisms are potentially available for shareholders to sanction boards. However, these provisions are of a generic nature, and not specifically related to remuneration. They are also either less easily employed by shareholders or more partial in their effects, and they have been rarely utilised. They are considered unlikely to serve the purpose of bringing about behavioural change on remuneration in those boardrooms where that is needed.

In relation to the range of possible adverse consequences of a ‘two strikes’ regime, noted above, it is difficult to establish their likelihood or severity. However, a number of the points raised by participants appear credible, particularly that conflation of the vote on remuneration with that on directors could have a ‘chilling’ effect on the former.

In the Commission’s view, these problems can be substantially alleviated while maintaining a two strikes process by decoupling the vote on whether the board should stand for re-election from the vote on the remuneration report.

A mechanism to enable shareholders to make distinct calls on the remuneration report and on whether directors should recontest their positions, was put forward by the Australian Securities Exchange in its submission in response to the Discussion Draft. Under the ASX proposal, a ‘re-election resolution’ would be included in the papers for the annual general meeting. Shareholders could vote on the resolution at the time they voted on the remuneration report. If the second strike were triggered and the resolution passed by a majority, all elected directors would automatically have to stand for re-election. If this were at an extraordinary general meeting within 90 days, uncertainty would be minimised.

This ‘two strikes and resolution’ variant would reduce the potential for conflation effects impacting on the vote on the remuneration report, as well as avoiding the situation of an unnecessary extraordinary general meeting.

What should the second strike trigger be?

A remaining key design issue is the appropriate threshold for the second strike — that is, what vote should trigger the re-election resolution? In the ASX’s formulation, the trigger would be a vote greater than 50 per cent (as also proposed for the first strike). This has the advantage that the re-election resolution is activated by the same threshold vote needed to pass it, so there would be more potential for it to be carried and, if it were, a greater likelihood that this was due to concerns about remuneration rather than other motives.

However, voting on the re-election resolution would involve little cost or inconvenience, and if the resolution were passed by a majority, the company would clearly face major difficulties with its shareholders that would need to be confronted, even if these were not solely related to remuneration.

Among other considerations, a minority trigger could still have some 'chilling' effect on 'no' votes, particularly if institutions were very risk averse, or concerned about the motivations of other key shareholders. However, in the Commission's judgment, this effect is unlikely to be significant in most cases, as institutions that have concerns about the remuneration report, but wish to avoid a board re-election, have a separate vote on that matter. The experience has been that board members seeking re-election typically receive very high shareholder support even when shareholders vote against the remuneration report.

Similarly, any potential for perverse effects on board decision-making about remuneration, or on board capacity, would be greatly muted under this variant of a two strikes process. After all, before a board contemplated the prospect of having to stand for re-election, a vote of 25 per cent or more against one remuneration report would need to have been repeated a year later on the subsequent report — despite any actions the board took in the meantime — with a consequent separate vote on whether to have a re-election, and this needing to be carried by a majority. While the prospect of all this happening may not be as rare as 'being struck twice by lightening', as one participant expressed it, only boards that acted in a manner that appeared contemptuous of shareholders' views would have much to fear. And the Commission considers that this would be justified.

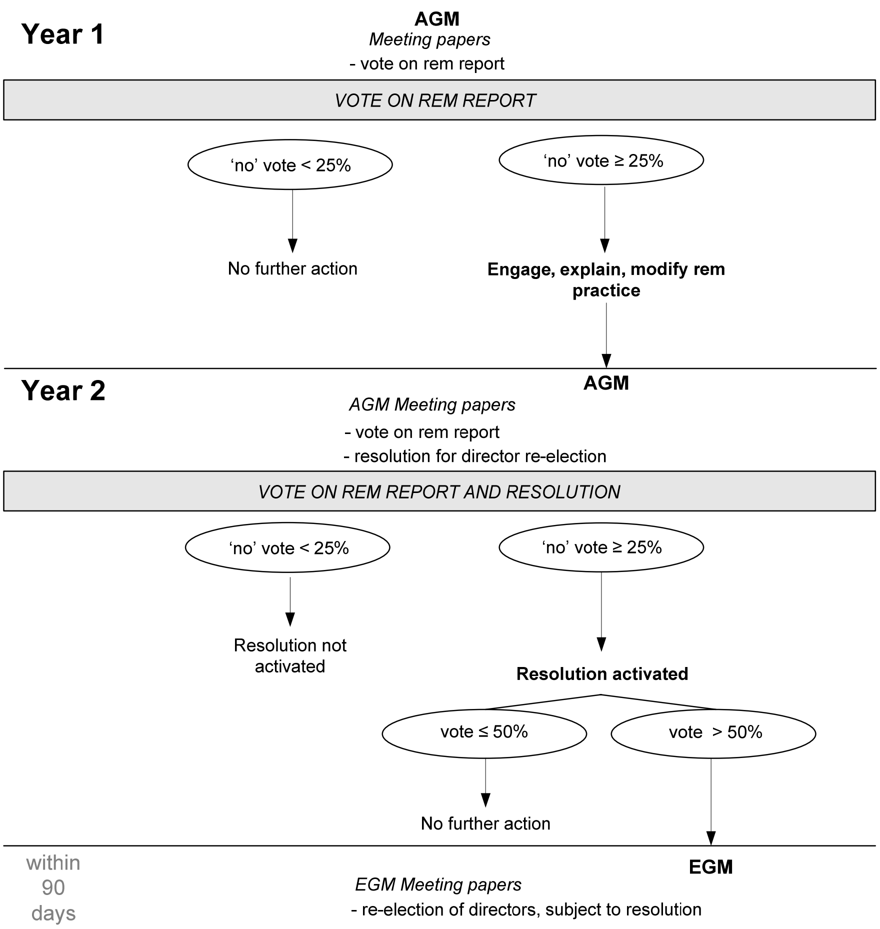
The revised recommendation

In short, the Commission considers that its revised proposal for a 'two strikes and re-election resolution' regime, with two voting triggers of 25 per cent, would encourage behavioural change where this was most needed, without having significant downside risks for other public companies. The key elements of the regime are depicted in figure 11.1

One further more detailed design issue relates to when the 'two strikes and re-election resolution' cycle is completed. The Commission's view is that once the resolution has been activated, the process should subsequently be re-set, irrespective of whether the resolution has been carried. To do otherwise would impose unnecessary cost — for example, if the resolution was not carried, little would be gained by requiring that it be repeated at the next general meeting, which could occur as early as nine months later. That said, non-carriage of the resolution should not obviate the requirement for the company to explain how shareholder concerns were addressed in the subsequent remuneration report.

Secondly, the Commission considers that, consistent with recommendations 4 and 6, directors and executives identified as key management personnel would be ineligible to vote their own shares, or undirected proxies held by them, in relation to remuneration reports or the resolution. This is desirable to maintain consistency with the signalling in the second strike vote, even though the wider shareholder group may vote differently at the general meeting. Normal voting protocols should apply, however, to the re-election of directors. (While some participants argued that sanctions should be triggered only by a majority vote based on issued shares, rather than votes cast, the Commission does not see a case for this departure from normal voting conventions.)

Figure 11.1 **The 'two-strikes and re-election resolution' process**



RECOMMENDATION 15

The Corporations Act 2001 should be amended such that:

- ***where a company's remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at an annual general meeting (AGM), the board be required to explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why***
- ***where the subsequent remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at the next AGM, a resolution be put that the elected directors who signed the directors' report for that meeting stand for re-election at an extraordinary general meeting (the re-election resolution). Notice of the re-election resolution would be contained in the meeting papers for that AGM. If it were carried by more than 50 per cent of eligible votes cast, the board would be required to give notice that such an extraordinary general meeting will be held within 90 days.***

Definitions and machinery

- 'Elected directors' — excludes any director not required to submit for election (managing directors) under ASX listing rules.
- 'Eligible votes cast' — directors and executives identified as key management personnel would be ineligible to vote their own shares, or undirected proxies held by them, in relation to remuneration reports or the re-election resolution. Normal voting protocols would apply to the re-election of directors.
- 'Director re-election' — if the re-election resolution is carried, all board members would continue in their positions until the EGM, at which time elected directors would present individually for re-election. The terms of appointments for re-elected directors would continue as if uninterrupted.
- Re-setting the mechanism — if the re-election resolution is activated, irrespective of whether or not it is carried, the entire process would be re-set. However, the requirement to explain how shareholder concerns were addressed in the subsequent remuneration report would stand.

11.7 Adding it up

The Commission's recommendations are directed at improving alignment between the interests of executives, shareholders and the boards that represent them, thereby achieving better remuneration (and other) outcomes over time.

Implementation

Taken as a whole, the proposed reform package shifts the balance of influence among management, boards and shareholders in the direction of the latter through increased disclosure, addressing conflicts of interest, increasing shareholder signalling through voting and potentially their capacity to sanction boards (see table 11.2, which also notes changes from the Discussion Draft recommendations). In doing so, it should reduce the likelihood in future of remuneration outcomes that shareholders would find objectionable, and help secure greater confidence in the corporate sector within the wider community.

In addition to legislative amendments to the Corporations Act, this reform package requires the Australian Securities Exchange (ASX) and the ASX Corporate Governance Council to agree to, and implement, the recommendations that relate to listing rules and 'if not, why not' requirements. If agreement is not forthcoming, these reforms would need to be secured by legislative means. (This less preferable course of action could result in some diminution of benefits if the desirable flexibility inherent in 'if not, why not' requirements were not achievable.)

RECOMMENDATION 16

If the Australian Securities Exchange does not give effect to recommendations 3 or 11 and/or the Australian Securities Exchange Corporate Governance Council does not give effect to recommendations 2 or 10, the Australian Government should give consideration to putting into effect the intent of those recommendations through legislative means.

A post-implementation review

Although the Commission has given careful consideration to the potential ramifications of its recommendations, both individually and collectively and considers that they are proportionate to the problems identified and unlikely to have significant downsides, any such proposals involve judgment. There is always the possibility of unintended consequences in such a complex and interactive system.

Also, as noted, some of the Commission's recommendations involve amendments to the Corporations Act and ASX listing rules. While these are considered appropriate within the current regulatory and institutional settings, the Government has signalled changes to the balance between the Australian Securities Exchange and the Australian Securities and Investments Commission, and the potential for additional entities to operate in competition with the ASX. It appears that the most likely outcome from having additional entities compete with the ASX is the emergence of competitive trading platforms for participants listed on the ASX market, but retention of a single listing (regulatory) platform. However, it needs to be recognised that there could be changes in future that bear on the regulatory architecture.

For all of these reasons, it would be desirable to evaluate the outcomes of the Government's response to the Commission's suite of recommendations within five years. This would also provide an opportunity to assess the impacts and effectiveness of the Government's recent legislative reforms in the related areas of termination payments and employee share schemes.

RECOMMENDATION 17

There should be a review of the corporate governance arrangements that emanate from the Australian Government's response to this report. The review should be conducted no later than five years from the introduction of the new arrangements. In particular, the review should consider:

- ***the effectiveness and efficiency of the reforms in meeting their objectives both individually and as a package, including recent legislative reforms to termination payments and employee share schemes***
- ***any changes to the regulatory architecture that affects the operations of, or the balance of responsibilities between, the Corporations Act 2001, the Australian Securities Exchange listing rules and the Australian Securities Exchange Corporate Governance Council's principles and recommendations.***

Table 11.2 **How the final recommendations differ from those in the Discussion Draft**

Final report recommendation	*Variations from Discussion Draft proposals*
Board capacities	
1. Any declaration of ‘no vacancy’ at an AGM to be agreed to by shareholders.	Objective unchanged, but more clarity on process and scope to retain flexibility.
Finding 1: *Support an ‘if not, why not’ requirement for boards to report progress against gender objectives.*	New finding.
Conflicts of interest	
2. On an ‘if not, why not’ basis: • remuneration committees to comprise at least three members, all non-executive directors, with a majority and the chair independent • companies to have a charter setting out procedures for non-committee members attending meetings.	Additional requirements to exclude executives and for transparent procedures relating to non-committee members attending meetings. (Previously draft recommendation 3.)
3 For ASX300 companies, executives to be prohibited from sitting on remuneration committees. (Listing rule)	Criteria for composition of remuneration committees removed to avoid problems of ‘black letter’ prescription of ‘independence’. Instead, composition reinforced through recommendation 2 (‘if not, why not’) for all listed companies. This approach allows necessarily flexible interpretation of ‘independent’. (Previously draft recommendation 2.)
4. Prohibit executives and directors voting their own shares on remuneration reports.	Reference to ‘associates’ removed. Confined to remuneration reports and resolutions related to those reports. Mechanism to target companies, not individuals.
5. Prohibit executives hedging unvested equity remuneration or vested equity subject to holding locks.	Reference to ‘associates’ removed.
6. Prohibit executives and directors voting undirected proxies on remuneration reports.	Reference to ‘associates’ removed. Confined to remuneration reports and resolutions related to those reports.
7. Require proxy holders to cast all their directed proxies on remuneration reports.	Confined to remuneration reports and resolutions related to those reports.
Disclosure	
8. Improve information content and accessibility of remuneration reports through: • a plain English summary of remuneration policies • reporting actual remuneration received and total company shareholdings of individuals in the report. Expert panel to advise on revised Corporations Act architecture to support changes.	Principles refined and a procedural mechanism to progress implementation incorporated.

(Continued next page)

Table 11.2 (continued)

Final report recommendation	*Variations from Discussion Draft proposals*
9. Remuneration disclosures to be confined to key management personnel.	No change
10. Companies to disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company. ('If not, why not')	Confined to advice on director and executive remuneration. (Previously draft recommendation 11.)
11. For ASX300 companies, advisers on executive pay to be commissioned by, and their advice provided directly to, the board, independent of management. (Listing rule)	Confined to advice on director and executive remuneration. New disclosure requirement. (Previously draft recommendation 10.)
12. Institutional investors to voluntarily disclose how they have voted on remuneration reports (and other remuneration-related issues).	In relation to compulsory superannuation contributions, monitoring to increase leverage on relevant bodes to implement recommendation.
Remuneration principles	
13. Remove cessation of employment as the taxation point for deferred equity subject to risk of forfeiture.	Clarification to confine recommendation to equity or rights subject to risk of forfeiture.
Finding 2: *Remuneration 'check list' for boards to improve information content in remuneration reports.*	Minor modifications in relation to benchmarks for executive pay and the operation of any deferral or forfeiture conditions.
Shareholder engagement	
14. Confirm allowance of electronic voting without amendment to company constitutions.	No change.
15. 'Two strikes and re-election resolution': • 25 per cent 'no' vote on remuneration report triggers reporting obligation on how concerns addressed • subsequent 'no' vote of 25 per cent activates a resolution for elected directors to submit for re-election within 90 days.	Introduction of mechanism to simultaneously trigger a resolution for a director re-election on achievement of second strike threshold, rather than proceed directly to re-election. Architecture and process clarified.
Implementation issues	
16. The Australian Government to implement intent of recommendations 2, 3, 10 and 11 by legislation if the ASX and Corporate Governance Council do not make the requisite changes.	New recommendation.
17. Review within five years to consider: • the effectiveness and efficiency of the reforms, including to termination payments and employee share schemes • the regulatory architecture.	New recommendation.

APPENDIX A

A Public Consultation

This appendix outlines the inquiry process and lists the individuals and organisations that have participated.

Following receipt of the terms of reference on 19 March 2009, the Commission placed a notice in the major metropolitan press inviting public participation in the inquiry. It released an issues paper in early April to assist participants to prepare their submissions. Prior to the release of the discussion draft in September 2009, the Commission received 105 initial submissions. After the Commission's discussion draft was released, a further 65 submissions were received (table A.1). Submissions were received from the key stakeholder associations, companies, governance consulting firms, remuneration consultants, proxy advisers, legal firms, unions, academics, retail shareholders and some members of the public.

The Commission conducted meetings and roundtables with a range of interested parties, predominantly in the financial centres of Sydney and Melbourne (tables A.2, A.3, A.6 and A.7). It also sought advice on taxation matters from Professor Rick Krever (Monash University). Commissioners also made presentations to various industry fora (tables A.4 and A.8).

An initial round of public hearings was held in Sydney, Melbourne and Brisbane in June and July, which attracted 30 participants (table A.5). A second round of public hearings was held in Melbourne and Sydney in October and November which attracted a further 18 participants (table A.9).

Table A.1 **Submissions**

Participant	*Submission number*[a]
Allens Arthur Robinson, Guerdon Assoc, CGI Glass Lewis and Regnan (joint submission)	DD168, DD170
ARAM Investment Services P/L	DD116
Australian Securities and Investments Commission	DD162
ASX Corporate Governance Council	73, DD141
Australian Bankers' Association	70*, DD135
Australasian Compliance Institute	31
Australian Council of Super Investors (ACSI)	71#, DD156
Australian Council of Trade Unions (ACTU)	82
Australian Chamber of Commerce and Industry	47
Australian Employee Ownership Association	76
Australian Human Resources Institute (AHRI)	49, 104, DD114
Australian Industry Group	48, DD151
Australian Institute of Company Directors (AICD)	59#, DD149
Australian Manufacturing Workers' Union	44, DD127
Australian Securities Exchange (ASX)	64, DD142
Australian Shareholders' Association (ASA)	54, DD121
Beattie, David	DD155
BHP Billiton	45, DD143
Bloomfield, David	14
BlueScope Steel	56, DD140
Boral	DD123
Braby, Robert	60
Bradley, Graham	30
Bricknell, Raymond	17
Buchanan, Neil	10
Business Council of Australia (BCA)	101, DD152
Caux Round Table	35
Chartered Secretaries Australia	5, DD147
CGI Glass Lewis and Guerdon Associates	80
Construction, Forestry, Mining and Energy Union (CFMEU)	78
CPA Australia	DD148
CPA Australia, The Institute of Chartered Accountants and the National Institute of Accountants (The Joint Accounting Bodies)	77
CRA Plan Managers	103
Dean, Prof Graeme	67#
Dobson, Lyne	23
Donovan, Andrew and Tunjic, Peter	81
Egan Associates	105*, DD160
Ernst and Young	92, DD136
FIL Investment Management (Australia)	83
Finance Sector Union	39, DD126
Fox, Robert	15
Fraser, Malcolm	DD166

(Continued next page)

Table A.1 (continued)

Participant	Submission number[a]
Freehills	46, DD130
Gattenhof, Adrian	DD120
Giles, Jack	5
Gnanadickam, Ravi	29
Guerdon Associates	DD119, DD163
Hay Group	84, DD132
Hector, Donald	DD133
Hicks, Fay	25, DD122
Hills, Rodger	26
Hogbin, Geoff	99, DD134
Holmans Accounting	1
Hundley, Ian	37
In Tempore Advisory	86
Institute of Chartered Accountants in Australia	DD146
International Institute for Self-governance	34
Investment and Financial Services Association (IFSA)	90, DD144
Jacoby, Dr Jack	7
Johnson, Arthur	DD107
Johnson, Jill	27
Kealy, Leonce	20
Klemm, Barrie	68
Kovacevic, Dr Savo (Sam)	43
KPMG	95, DD145
Kyneton Branch ALP	33
La Brooy, Michael	40
Lance, John	79, 97
Law Council of Australia	DD150
Lenehan, Susan	38
Macek, Charles	55
Mackenzie, Dr Colin	88, DD117
Macquarie Group	52, DD157
Maxumise Consulting	69
May, Owen	DD125
Mayne, Stephen	63, 100
McAuley, Ian	11
McGregor, William	24
Mercer	41, DD139
Mercer, Stephen	DD109
Miller, Peter	DD108
Moss, Dr Simon	2
Murray, Andrew	28, DD112
Murrie, Bruce	18

(Continued next page)

Table A.1 (continued)

Participant	*Submission number*[a]
National Australia Bank	DD153
Noonan, Maureen	3
O'Donnell, Carol	16, DD113
Oldfield, Elizabeth	98
Oppeus	61*
Origin Energy	93, DD129
Park, Kenneth	21
Peetz, David	50
Perpetual	DD128
Piljic, Rad	87
Potter, Allan	75, DD115
PricewaterhouseCoopers	85, DD138
Primary Industries and Resources South Australia	66*
Regnan Governance Research and Engagement (Regnan)	72, DD159, DD169
Remuneration Strategies Group	89
Remuneration Tribunal	102
RiskMetrics	58, DD164
Robitaille, Patrick	51
Russell, Rev Michael	DD106
Sainsbury, Mark	DD124
Scampoli, Lou	DD110
Segal, Jillian	DD167
Shah, Rajan	42
Sheehan, Kym	36, DD137
*SIM*METHOD	32
Sirtex	DD165
Simpson, Geoff	DD154
Steiner, Carol	6,13
Stekhoven, W Stephen	4
Stern Stewart and Co	53
Stocker, Margrit	62, DD161
Tetley, Tim	94
The Australia Institute	DD131
The HR Nicholls Society	74
Thompson, Ken	19
Tusa, John	22
Unisuper	DD118
Vanderlaan, Michael	9
Versteegen, J and V	12
Wesfarmers	65
West, Norman	DD111
Westpac	DD158
Woldring, Klaas	8
Woolworths	91#

[a] A hash (#) indicates that the submission includes attachments. An asterisk (*) indicates that the submission includes confidential information not available to the public.

Table A.2 **Pre discussion draft visits**

Participant (grouped by visit location)
Canberra
Australia's Future Tax System Secretariat
Treasury
Melbourne
Australian Council of Super Investors
Australian Council of Trade Unions
Australian Securities and Investments Commission
Business Council of Australia
Deloitte
Egan Associates
Ernst and Young
Hay Group
KPMG
Michael Chaney (Chairman of NAB, Woodside Petroleum and Gresham Partners Holdings)
PricewaterhouseCoopers
RiskMetrics
Sydney
AMP Capital Investors
Association of Superannuation Funds of Australia
Australian Bankers' Association
Australian Institute of Company Directors
Australian Prudential Regulation Authority
Australian Securities Exchange
Australian Securities and Investments Commission
Australian Shareholders' Association
Fidelity International
Future Fund
Guerdon Associates
Intech
Investment and Financial Services Association
Schroders Investment Management
Westpac
Brisbane
Queensland University of Technology

Table A.3 **Roundtable discussions organised by the Business Council of Australia (pre discussion draft)**

Participant
Roundtable of chief executive officers — Sydney 2 June 2009
Accenture Australia
Alumina
Business Council of Australia
Credit Suisse Australia
CSR
Ernst and Young
Freehills
Macquarie Group
Perpetual
PricewaterhouseCoopers
Thales Australia
Roundtable of chairman — Sydney 2 June 2009
Amcor
Australian Unity
Business Council of Australia
Boral
Clayton Utz
David Jones
Freehills
Macquarie Group
Origin Energy
Perpetual

Table A.4 **Commissioner presentations to industry fora (pre discussion draft)**

Commissioner	*Forum*	*Date/s*
Gary Banks	Financial Services Institute of Australasia (FINSIA)	3 and 4 June 2009
Allan Fels	Australian Human Resources Institute	17 July 2009

Table A.5 **Pre discussion draft public hearings**

Participant
Sydney 16 June 2009
CGI Glass Lewis and Guerdon Associates
Regnan Governance Research and Engagement
Australian Shareholders' Association
Dr Klaas Woldring
Australian Employee Ownership Association/International Institute for Self-governance
Construction, Forestry, Mining and Energy Union
Investment and Financial Services Association
Australasian Investor Relations Association
Sydney 17 June 2009
Chartered Secretaries Australia
Australian Human Resources Institute
Australasian Compliance Institute
Rodger Hills
Maxumise Consulting
Freehills
Australian Institute of Company Directors
Melbourne 24 June 2009
Dr. Jack Jacoby
Stephen Mayne
Ian Hundley
CPA Australia, the Institute of Chartered Accountants in Australia and the National Institute of Accountants (The Joint Accounting Bodies)
Remuneration Strategies Group
Andrew Donovan and Peter Tunjic
Melbourne 25 June 2009
Australian Council of Super Investors
Mercer
Finance Sector Union
RiskMetrics
KPMG
Norman Geschke
Brisbane 10 July 2009
In Tempore Advisory
Australian Institute of Management
Effective Governance

Table A.6 **Post discussion draft visits**

Participant (grouped by visit location)
Sydney
Australian Securities Exchange
Spencer Stuart

Table A.7 **Roundtable discussions (post discussion draft)**

Participant
Roundtable of chairman and chief executive officers — Sydney 16 November 2009 (organised by the Business Council of Australia)
ABB Australia
Accenture Australia
Allens Arthur Robinson
Australian Investment Banking Credit Suisse
Bilfinger Berger
Boral
Business Council of Australia
Commonwealth Bank of Australia
Downer EDI
Dupont
Foxtel
Freehills
Mallesons
Origin Energy
PricewaterhouseCoopers
Qantas
Sinclair Knight Merz
Suncorp-Metway and TabCorp
Diversity Roundtable — Melbourne 23 November 2009
Katie Lahey
Siobhan McKenna
Elizabeth Proust
Jillian Segal

Table A.8 **Commissioner presentations to industry fora (post discussion draft)**

Commissioner	*Forum Organiser*	*Date/s*
Gary Banks	ACSI	1 October 2009
Gary Banks/Allan Fels	Committee for Economic Development of Australia	7 October 2009
Gary Banks	ACT Economic Society	14 October 2009
Gary Banks	Guerdon Associates, CGI Glass Lewis, Allens Arthur Robinson	19 October 2009
Allan Fels	Mercer	19 October 2009
Robert Fitzgerald	Mercer	23 October 2009
Robert Fitzgerald	Financial Institutions Remuneration Group	23 October 2009
Robert Fitzgerald	KPMG	26 October 2009
Gary Banks	Hay Group	28 October 2009
Gary Banks	Freehills	11 November 2009

Table A.9 **Post discussion draft public hearings**

Participant
Melbourne 27 October 2009
Australian Human Resources Institute
Norm West
Australian Council of Trade Unions
Sydney 9 November 2009
KPMG
Regnan Governance Research and Engagement
Institute of Chartered Accountants in Australia
Sydney 10 November 2009
Guerdon Associates
Chartered Secretaries Australia
Australian Institute of Company Directors
CPA Australia
Australian Shareholders' Association
Adrian Gattenhof
Malcolm Fraser
Melbourne 13 November 2009
Ernst and Young
Hay Group
Business Council of Australia
Australian Council of Super Investors
RiskMetrics

APPENDIX B

B Remuneration data

This appendix describes the data sources used by the Commission to investigate trends in director and executive remuneration and presents some further evidence of trends that were identified in chapter 3.

B.1 Data sources

The Commission used a number of data sources to investigate trends in director and executive remuneration. Most of the sources are publicly available, however some of the data were supplied to the Commission by remuneration consultants using data drawn from their private databases. The data cover various spans over the period 1988–2009.

The most comprehensive source of data that the Commission was able to access was the Financial Review Executive Salary Database. This database, and the adjustments applied to the data are described in detail below. Other, less-detailed, sources of time-series data on director and executive remuneration are also described.

The Financial Review Executive Salary Database

The Financial Review Executive Salary Database contains publicly-disclosed data from the remuneration reports of ASX300 companies for each financial year over the period 2003-04 to 2008-09. The database includes remuneration data for all executives named in the remuneration reports, including chief executive officers (CEOs) and other executives. For each executive, the database includes the following information:

- the executive's name and position
- the name of the company, its market capitalisation and number of employees in 2008-09, and its industry classification under the Global Industry Classification Standard (GICS)

- the executive's base salary, superannuation, retirement benefits and other payments (which could include costs such as car allowances, life insurance, legal and tax advice)
- the executive's 'base total' salary, which includes all of the above elements of remuneration
- the value of any short-term incentives paid during the year
- the estimated value of any long-term incentives granted.

In some cases the database includes commentary on the nature of any performance hurdles that the executive was subject to. However, this information is not presented for all executives, or in any consistent format. The database does not describe the nature of long-term incentives or the payment vehicles used (such as options, shares or performance rights).

In order to construct a consistent set of data, it was necessary to make a number of alterations to the data, and to exclude some records. The adjustments used are described briefly below.

Only full year employees were included

The database included records of executives who were appointed during the year, and others who departed before serving the full year. The remuneration of executives who did not serve a full year could have included accrued entitlements that were paid out on departure, and it was not possible to reliably estimate the pro-rata annual remuneration that the executive would have received for a full year of service. For these reasons, all records of executives who did not serve a full year were excluded from the sample.

Executives were broken down into CEOs and non-CEOs

For the purposes of the analysis, executives were divided into two categories: CEOs and non-CEO executives. This was done because CEOs generally receive significantly higher levels of remuneration than other executives, have more responsibilities and ability to influence company performance, and are subject to greater scrutiny.

The division of executives into CEOs and others was based on a consideration of position titles. Company annual reports were consulted to confirm decisions as necessary. CEOs were defined as the most senior (and generally highest-paid) executive employed by a company. Aside from a small number of cases where executives were designated as joint CEOs, only one executive was designated as a CEO for each company.

Generally, executives whose title was ‘Chief Executive Officer’, ‘CEO’ or ‘Managing Director’ were classified as CEOs. Some other position titles were also classified as CEOs, including some executives whose title was ‘Executive Chairman’ and some combined roles, such as ‘Chief Executive Officer and Chairman of the Board’. Where job titles designated executives as divisional CEOs (such as ‘CEO Sugar’ or ‘CEO Victoria’), the executive was designated as a non-CEO.

All executives who were not classified as CEOs were classified as non-CEO executives. The data set also included some non-executive directors and non-executive chairs. These records were excluded from the analysis of executive remuneration.

Remuneration was converted into Australian dollars

A small number of executives were reported as being paid in currencies other than Australian dollars. The most common alternative currency was US dollars, with a few executives being paid in Pounds sterling, New Zealand dollars, Singapore dollars and Euros.

Where executives were paid in currencies other than Australian dollars, their remuneration was converted into Australian dollars using conversion factors that are included in the Financial Review Executive Salary Database.

Descriptive statistics

Descriptive statistics for the data sets drawn from the Financial Review Executive Salary Database for each year from 2003-04 to 2008-09 are set out in tables B.1 and B.2. The statistics are based on the samples that were derived using the adjustments described above.

Table B.1 **Descriptive statistics: ASX300 CEOs**

Data from the Financial Review Executive Salary database

				Average remuneration (nominal)				
Year	*Number*	*Paid foreign currency*	*Not full year*[a]	*Base salary*	*Base total*[b]	*STI*[c]	*LTI*[d]	*Total*[e]
				$'000	$'000	$'000	$'000	$'000
2003-04	247	7	26	654	1 094	552	194	1 673
2004-05	229	9	28	741	967	664	352	1 980
2005-06	249	12	49	744	925	664	430	2 019
2006-07	222	12	47	884	1 127	971	732	2 830
2007-08	233	13	46	949	1 263	848	807	2 917
2008-09	228	12	66	991	1194	583	594	2 371
				Median remuneration (nominal)				
				Base salary	*Base total*[b]	*STI*[c]	*LTI*[d]	*Total*[f]
				$'000	$'000	$'000	$'000	$'000
2003-04				497	724	150	11	979
2004-05				550	630	200	90	1 149
2005-06				538	622	207	123	1 090
2006-07				627	732	307	248	1 439
2007-08				694	792	300	380	1 700
2008-09				717	794	133	216	1 322

[a] The number of CEOs that were excluded from the sample because they did not serve a full year. [b] Includes base salary, superannuation, retirement benefits and other payments. [c] Short-term incentive. [d] Long-term incentive. [e] Does not necessarily equal the sum of average base total, STI and LTI, because total remuneration can also include other payments that are not included in the other three categories. [f] Does not equal the sum of the medians of base total, STI and LTI, because medians are not additive.

Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Table B.2 **Descriptive statistics: ASX300 non-CEO executives**

Data from the Financial Review Executive Salary database

Year	Number	Paid foreign currency	Not full year[a]	Average remuneration (nominal) Base salary	Base total[b]	STI[c]	LTI[d]	Total[e]
				$'000	$'000	$'000	$'000	$'000
2003-04	1 062	27	78	342	554	186	81	740
2004-05	1 135	35	150	360	473	280	109	864
2005-06	1 256	60	219	363	458	297	148	903
2006-07	1 241	91	288	418	544	396	280	1 220
2007-08	1 212	47	386	415	512	329	305	1 146
2008-09	1 281	87	489	447	554	203	208	965
				Median remuneration (nominal)				
				Base salary	Base total[b]	STI[c]	LTI[d]	Total[f]
				$'000	$'000	$'000	$'000	$'000
2003-04				252	356	57	11	433
2004-05				277	336	58	24	463
2005-06				293	349	80	39	475
2006-07				338	400	123	79	663
2007-08				325	383	101	81	612
2008-09				357	410	54	74	610

[a] The number of executives that were excluded from the sample because they did not serve a full year. [b] Includes base salary, superannuation, retirement benefits and other payments. [c] Short-term incentive. [d] Long-term incentive. [e] Does not necessarily equal the sum of average base total, STI and LTI, because total remuneration can also include other payments that are not included in the other three categories. [f] Does not equal the sum of the medians of base total, STI and LTI, because medians are not additive.

Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Division of data into industry sectors

The Financial Review Executive Salary Database specifies the industry sector in which each executive is employed, according to the Global Industry Classification Standard (GICS). In total, 11 industry sectors are identified in the database.

The Commission used these definitions as the basis of an analysis of trends in executive remuneration across industry sectors (chapter 3). To simplify the analysis, the 11 industry sectors were combined into 8 categories (table B.3).

Table B.3 **Definition of industry sectors**

Industry sector used by Productivity Commission	*GICS industry sectors included and activities carried out in the sector*
Financial	**Financials** • banks; diversified financials; insurance. **A-REIT** • real estate investment trusts.
Industrial	**Industrials** • capital goods (aerospace and defence; building products; construction and engineering; electrical equipment; industrial conglomerates; machinery; trading companies and distributors) • commercial and professional services • transportation.
Consumer	**Consumer staples** • food and staples retailing; food, beverage and tobacco; household and personal products. **Consumer discretionary** • automobiles and components; consumer durables and apparel; consumer services; media; retail.
Materials and energy	**Materials** • metals and mining • paper and forest products • containers and packaging • construction materials • chemicals. **Energy** • oil and gas exploration, drilling, production, refining, marketing, storage and transportation; manufacturing of equipment for the oil and gas sector • mining and production of coal.
Health care	**Health care** • health care equipment, technology, providers and services • pharmaceuticals; biotechnology; and life sciences.
Information technology	**Information technology** • software; internet services; information technology services • technology, hardware and equipment.
Utilities	**Utilities** • electric, gas, water and other utilities.
Telecommunications	**Telecommunications services** • fixed-line, wireless and high-bandwidth cable service providers.

Source: ASX (2008c).

Random sample of companies outside the ASX300

There are close to 2000 entities listed on the Australian Securities Exchange (ASX), most of them significantly smaller than ASX100 or ASX300 companies. Many of the smaller entities are disclosing entities for the purposes of section 111AC of the Corporations Act, and therefore fall within the terms of reference of this inquiry.

To gain an understanding of executive remuneration practices outside the ASX300, the Commission took a random sample of companies outside the ASX300 and examined their remuneration practices for 2008-09. The procedure for generating the data was:

- The Commission obtained a list of all companies listed on the ASX as of 27 June 2009, and their market capitalisation.
- Companies outside the ASX300 were divided into four groups according to their market capitalisation: 301–500, 501–1000, 1001–1500, and 1501–1871.
- For each of the groups, each company in the group was assigned a random number using the Microsoft Excel random number generator. The companies were sorted by the random number, in ascending order.
- Working through the list, the first 20 companies in each group (as ranked by the random number) that had released remuneration reports for 2008-09 were selected, and their remuneration reports examined (companies are listed in table B.4).
- As with the Financial Review Executive Salary Database, executives were divided into CEOs and non-CEO executives on the basis of their job titles. Executives who did not serve a full year were excluded from the analysis.

The data show that executives at companies outside the ASX300 generally received lower average remuneration than ASX300 company executives. On average, the smaller the market capitalisation of the company, the lower the average remuneration and the smaller the proportion of that remuneration that was paid in the form of incentive-based payments (table B.5).

Table B.4 **Companies included in sample of companies outside the ASX300**

Companies were randomly selected

Group (ranked by market capitalisation on 27 June 2009)	*Companies in group*
301–500	Aditya Birla (ABY), Aspen Group Stapled (APZ), Austbrokers Holdings (AUB), Biota Holdings (BTA), Crescent Gold (CRE), CSG (CSV), Data#3 (DTI), Finbar Group (FRI), Horizon Oil (HZN), Infomedia (IFM), Integra Mining (IGR), Iinet (IIN), Mitchell Communication Group (MCU), Patties Foods (PFL), Redflex Holdings (RDF), Retail Food Group (RFG), Templeton Global (TGG), Talent2 International (TWO), United Overseas Australia (UOS), Wilson HTM Investment Group (WIG).
501–1000	Austin Engineering (ANG), Apex Minerals (AXM), Centrebet International (CIL), Clinuvel Pharmaceuticals (CUV), Cedar Woods (CWP), Forte Energy (FTE), HFA Holdings (HFA), Iron Ore Holdings (IOH), Liquefied Natural (LNG), Metgasco (MEL), MEO Australia (MEO), M2 Telecommunication (MTU), Norton Gold Fields (NGF), Norseman Gold (NGX), Oaks Hotels and Resort (OAK), Probiotec (PBP), Phosphagenics (POH), RR Australia (RRA), Select Harvests (SHV), Tutt Bryant Group (TBG).
1001–1500	Adcorp Australia (AAU), Autron Corporation (AAT), Austex Oil (AOK), CBD Energy (CBD), Chalmers (CHR), Coalworks (CWK), Copper Strike (CSE), Cogstate (CGS), Everest Financial (EFG), Gage Roads Brewing (GRB), GME Resources (GME), Indo Mines (IDO), Krucible Metals (KRB), Morning Star Gold (MCO), Netcomm (NTC), Phosphate Aus. (POZ), PPK Group (PPK), Ross Human Direction (RHD), Silver Chef (SIV), Tranzact Financial Services (TFS).
1501–1871	Ashburton Minerals (ATN), Avanco Resources (AVB), Brand New Vintage (BNV), Buccaneer Energy (BCC), Carbon Conscious (CCF), Cobar Consolidated (CCU), Cockatoo Ridge Wines (CKR), Connxion (CXN), Cool Or Cosy (COS), Dart Mining (DTM), Freshtel Holdings (FRE), Gulf Mines (GLM), India Resources (IRL), Midas Resources (MDS), Mount Burgess Mining (MTB), Resource Base (RBX), Sirius Corp (SIU), Syndicated Metals (SMD), Telezon (TLZ), Westralian Gas And Power (WGP).

Table B.5 **Average executive remuneration outside the ASX300, 2008-09**

Company rank (by market capitalisation)	*Base salary*	*Base total*	*STI*[a]	*LTI*[b]	*Total remuneration*	*Number of observations*
CEOs	$'000	$'000	$'000	$'000	$'000	No.
301–500	335	397	91	100	595	20
501–1000	386	426	50	180	651	20
1001–1500	228	250	58	31	350	20
1501–1871	213	231	1	24	264	20
Non-CEO executives						
301–500	222	256	42	42	340	92
501–1000	193	222	23	52	299	80
1001–1500	148	173	36	22	232	50
1501–1871	133	145	2	13	160	28

[a] Short-term incentive. [b] Long-term incentive

Sources: Company annual reports; Productivity Commission estimates.

Time-series remuneration data

The Commission obtained other sources of data on trends in executive remuneration. These sources present time series of data on executive remuneration over various periods. They do not include company-by-company breakdowns of remuneration practices, and only two of the sources (Kryger (1999) and Hay Group (2009)) are presented in a way that enables analysis of trends in incentive-based remuneration separately from fixed (base) remuneration.

Kryger (1999)

Kryger (1999) published a research note on private sector executive remuneration for the Parliamentary Library. The note reported data on the average annual base salary, allowances and benefits, and incentive bonuses of CEOs from 1988 to 1998. The data were drawn from a survey conducted by remuneration consultants Mercer Cullen Egan Dell. Kryger did not disclose the identity of the companies included in the sample, or any information about their size or the industry sector they operated in.

Crichton / Remuneration Planning Corporation

Crichton (of the Remuneration Planning Corporation) published annual reports on director and executive remuneration in Australia's top 350 public companies over the period 1994 to 1998. The reports were intended for use by people responsible for making recommendations on the remuneration of directors and executives (such as board remuneration committees).

Crichton reported the remuneration of executives in bands (for example, the number of executives earning between $240 000 and $250 000). Based on this information, it was possible to estimate the median remuneration of directors and executives. Because the data were reported in bands, it was assumed that the median executive salary was equal to the mid point of the median band. For example, in 1994, the median remuneration band for CEOs was $340 000 to $360 000 (Crichton 1995, p. 12). For the purposes of this report, it was assumed that the median remuneration of CEOs in that year was $350 000. This might over or understate the true median of the data, but the error is likely to be relatively small.

Egan Associates

Egan Associates is a consultancy company that advises on director and executive remuneration. A predecessor of Egan Associates (Mercer Cullen Egan Dell) was the source of the data used by Kryger (1999). The Commission used three other data sources published by Egan Associates or its predecessors.

Korn/Ferry International and Egan Associates (2005) included a graph of the annual average and median remuneration of CEOs, the second highest paid executives and the top three executives in the top 50 companies in Australia over the period 1993 to 2004. The underlying data were captured using a process described by Harding (2008) (box B.1).

Egan (2009) included a graph of the median remuneration of CEOs, the second highest-paid executive and the top five executives at the top 100 companies over the period 1998 to 2008. The data were captured using the process described by Harding (2008) (box B.1).

Egan Associates (sub. 105) included graphs of remuneration in the top 100 companies (by market capitalisation) from 1988 to 2008, including:

- average remuneration of CEOs, ‘top 5’ executives, chairs and ‘top 5’ non-executive directors
- median remuneration of chairs and ‘top 5’ non-executive directors.

Egan Associates provided the Commission with the data underlying these graphs for 1993–2008. In addition, Egan Associates separately provided the Commission with data for 2009 (Egan Associates, pers. comm., 3 December 2009).

Box B.1 **Capturing data from graphs**

Some data series were only available in graphical form. To capture the underlying data the Commission used a process detailed in Harding (2008). This involved using the widely-available computer program ‘Paint’, which allows users to determine the coordinates of each data point on a graph. These data points can then be adjusted using a simple linear process to derive the original values of the data. This process was used to capture data from Korn/Ferry International and Egan Associates (2005), Egan (2009), Peetz (sub. 50), Frydman (2005), and Frydman and Saks (2007).

Using this process admits the possibility of measurement error. However, given the characteristics of the graphs and the nature of the underlying data, it is likely that any errors are small and would not have a significant influence on the conclusions reached from the data.

Hay Group

Hay Group is a consultancy company that provides advice on a range of organisational, management and performance matters, including executive remuneration. Hay Group provided the Commission with data on the level and growth rates of the remuneration of CEOs and other senior executives over the period 1995 to 2009. Executives’ remuneration was broken down into:

- Fixed Annual Reward — ‘the sum of base salary plus all allowances and benefits including medical, telephone, company cars, loans, club fees, car allowances plus employer and occupational superannuation’ (Hay Group 2009, p. 15)
- Aggregate Reward — the sum of fixed annual reward, actual short-term incentive payments and ‘total long-term incentive’ (Hay Group 2009, p. 15). The value of long-term incentives are ‘calculated using Hay’s proprietary long-term incentive valuation methodology and are annualized and reported as a cash equivalent’ (Hay Group 2009, p. 16). Hay Group does not include one-off equity grants, such as sign-on or retention awards, in its calculations of annual long-term incentive value.

The CEOs in the sample were categorised by the Hay Group into three groups according to the difficulty of the role they perform and the skills needed to carry it out. The Hay Group also provided data on the remuneration of ‘seasoned professionals’ (table B.6).

Table B.6 **Hay Group role definitions**

Role	*Definition (2009)*
CEO level 'A'	CEO of a diversified company utilising related technologies, with multiple product lines usually serving multiple, but related, markets. At the smaller end will involve a fully integrated and functionally complete business, utilising common or related technologies, products and markets. May involve international activities, but the main focus will be domestic. May include subsidiaries of overseas multi-nationals with significant activities in Australia or the Asia Pacific region. Typical dimensions are as follows: • Revenue: $750 million–$2.5 billion • Employees: 1500–8000.
CEO level 'B'	CEO of a diversified company utilising several unrelated technologies, products and markets within diverse business segments. Typically will involve significant R&D for product driven companies or significant marketing budgets for marketing driven companies. Usually will have significant international activities and a diverse shareholder base. Typical dimensions are: • Revenue: $2.5 billion–$8 billion • Employees: 5000–15 000.
CEO level 'C'	CEO of a complex, multinational business in which the company has taken on leadership characteristics in products and markets. Also diversified companies utilising several unrelated technologies, products and markets. Would typically involve significant research and development or significant marketing budgets. A diverse shareholder base. Typical dimensions are: • Revenue: $8 billion–$15 billion • Employees: In excess of 15 000 staff.
Senior executive	Typical roles in this grade: • Line managers responsible for a major business, typically reporting two levels below a CEO level C or directly to a CEO level B. • The functional roles at this level include Chief Financial Officers reporting to a CEO level B and Finance Directors of larger and more complex companies with a CEO level A. Covers human resources roles for the largest companies and major business development and strategy development roles.
Seasoned professional	Extensive professional knowledge about theoretical concepts and principles in a specialist field normally associated with a professional or academic qualification or considerable experience. Typically manages broadly similar sub-functions and integrates and coordinates relationships with other parts of the organization over a one year horizon. Interaction with others requires highly developed skills to motivate, inspire and persuade. Decision-making involves the use of judgment and there is an emphasis on the development of new/improved procedures and on the translation of policy into operational plans. The focus is on the delivery of medium-term results within functional policy and precedent and outputs are subject to periodic review against targets. Jobs typically have a direct and controlling impact on a key aspect of performance of a very small/small organisation.

Source: Hay Group (2009), pp. 17–19.

FinAnalysis database

Aspect Huntley's FinAnalysis database is a commercial online database that includes information from companies' annual reports and other disclosures, as well as share price data. The FinAnalysis database was used to obtain data on the market capitalisation of the companies in the Financial Review Executive Salary Database, as well as indicators of corporate performance, including total shareholder return, profits, return on equity and return on assets.

Deflation of time-series data

All time-series data on executive remuneration were adjusted to account for inflation. Nominal data were deflated using the Gross Domestic Product (GDP) implicit price deflator. The GDP implicit price deflator was preferred to other indexes of price changes (such as the consumer price index) because it relates to the prices that producers (companies) face for their outputs (ABS 2006). The same approach was used by Gabaix and Landier (2008).

Average weekly earnings across sectors

The Commission investigated the relationship between executive remuneration and average weekly earnings, including the relationship between the remuneration of executives in particular sectors with the average earnings of other employees in those sectors. To make the comparison, it was necessary to estimate the average weekly earnings (AWE) of employees in particular industry sectors.

The Australian Bureau of Statistics (ABS) publishes data on average weekly earnings across a range of industries. The ABS industry categories were used to compare the earnings of executives and other employees in some sectors (table B.7). Although the GICS classifications do not align perfectly with the industry classifications used by the ABS (which are based on the Australian and New Zealand Standard Industrial Classification), there is sufficient common ground between the two classification systems in the industries selected to allow comparison of executive remuneration and average earnings.

No comparison with average earnings was made for the information technology sector because no suitable comparator group could be found in the average weekly earnings statistics.

No comparison with average earnings was made for the telecommunications sector because the sector consists of only a small number of companies (either 3 or 4 depending on the year under consideration) and is dominated by Telstra, leading to a heavily-skewed estimate of average executive earnings.

Table B.7 **Industry comparisons of executive remuneration and average weekly earnings**

Executive sector[a]	*ABS industry for comparison*
Materials and energy	Mining
Financials	Finance and insurance
Health care	Health and community services
Utilities	Electricity, gas and water
Industrials	Average of: • Manufacturing • Wholesale trade • Transport and storage
Consumer	Average of: • Retail trade • Communication services • Culture and recreation services

[a] Sector as defined in table B.3.

Source: ABS (*Average Weekly Earnings, Australia*, Cat. no. 6302.0).

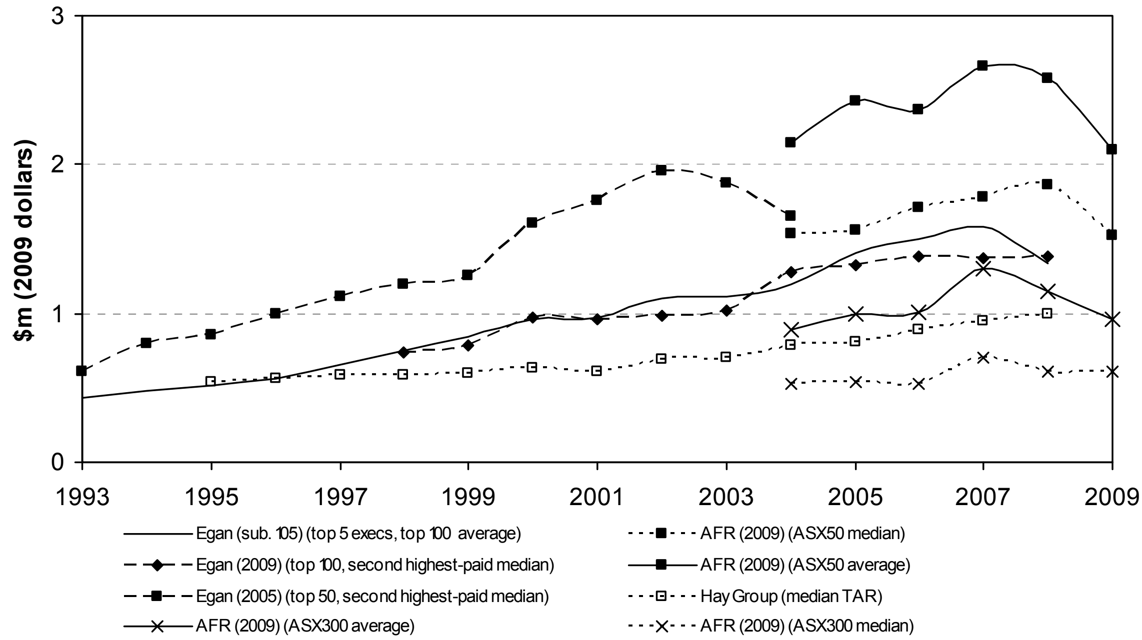
B.2 Further evidence on trends in executive remuneration

This section adds to the evidence presented in chapter 3 on trends in the size and structure of executive remuneration packages, and the relationships between executive remuneration and job complexity, company size and industry sector.

Trends in the remuneration of non-CEO executives

The longest-running time series of non-CEO executive remuneration data (Egan Associates, sub. 105) suggests that non-CEO executive remuneration followed similar trends to CEO remuneration. Average non-CEO executive remuneration grew at around 12 per cent per year in real terms over the period 1993–99, and by around 7 per cent per year for 2000–07. Average and median remuneration of non-CEO executives peaked in 2006-07, and has declined significantly since then (figure B.1). There is anecdotal evidence that the trend toward lower executive remuneration will continue in the coming year as companies announce freezes on executive remuneration in 2009-10 (chapter 3).

Figure B.1 **Non-CEO executive total remuneration, 1993–2009[a]**
2009 dollars (millions)



[a] Hay Group data refers to the median total annual reward (fixed remuneration plus short-term incentives, not including long-term incentives).

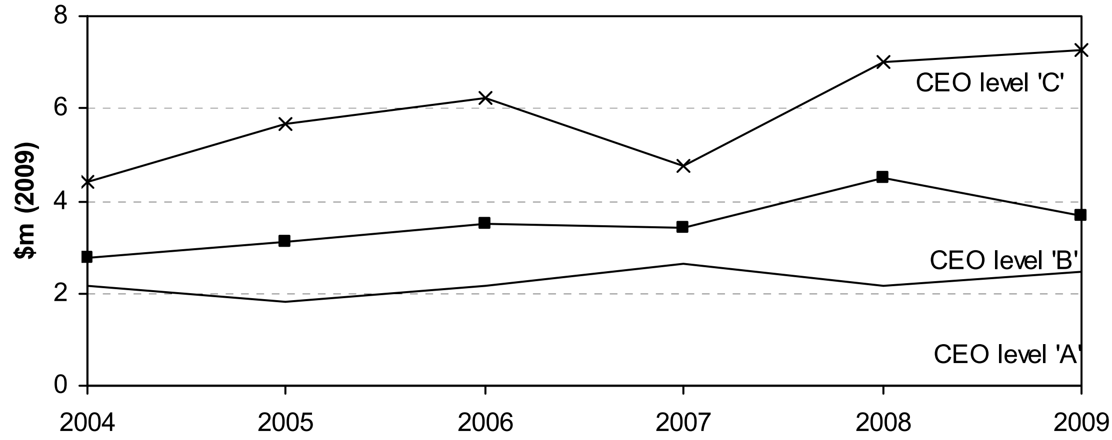
Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); Kryger (1999); Crichton (various years); Egan (2009); Egan Associates (sub. 105); Financial Review Executive Salary Database; Korn/Ferry International and Egan Associates (2005); Productivity Commission estimates.

CEO remuneration and job complexity

The Hay Group data were used to analyse trends in the remuneration of CEOs performing jobs of different 'levels' (table B.6). The data show that:

- over the period 2004–2008, aggregate reward was higher for CEOs of higher levels (figure B.2)
- over the period 2001–2008 there was a slowly-growing difference between the fixed remuneration of CEOs of different levels (figure B.3).

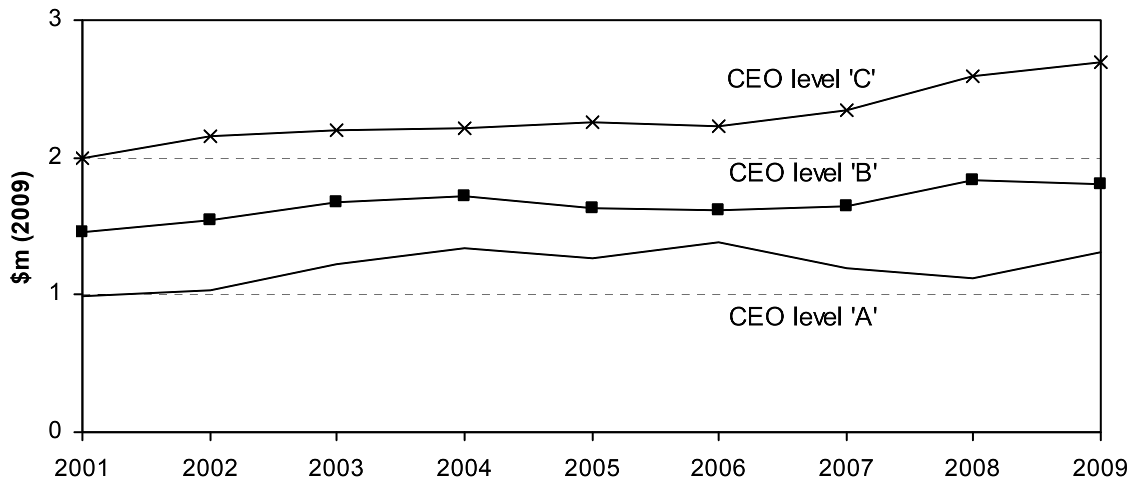
Figure B.2 **CEO median aggregate annual reward by CEO 'level'[a]**



[a] CEO level determined according to the Hay Group job evaluation methodology (table B.6).

Source: Hay Group (2009).

Figure B.3 **CEO median fixed annual reward by CEO 'level'[a]**



[a] CEO level determined according to the Hay Group job evaluation methodology (table B.6).

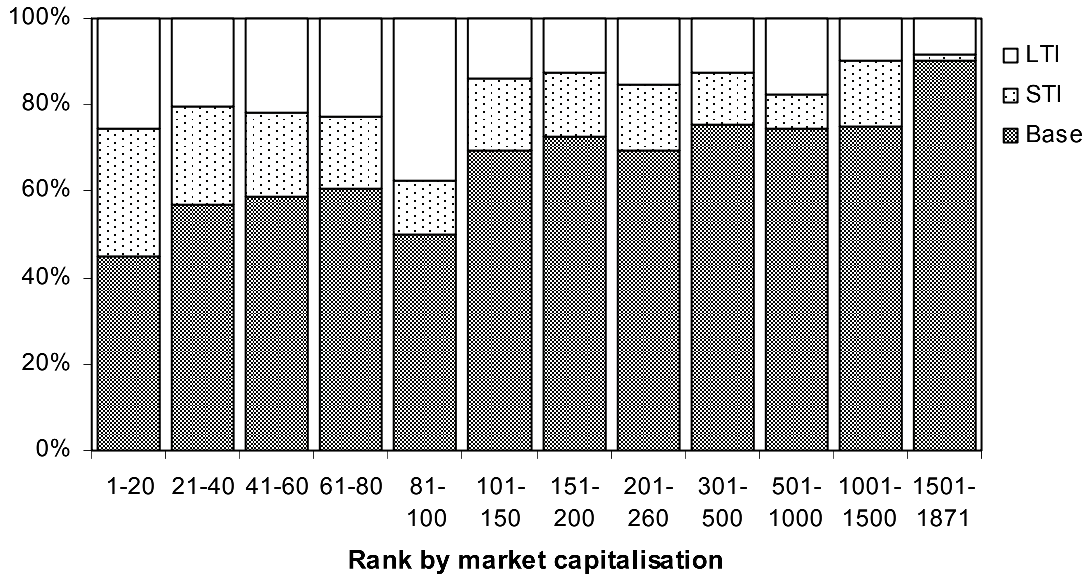
Source: Hay Group (2009).

The structure of executive remuneration

Evidence presented in chapter 3 shows that CEOs of larger companies receive a greater proportion of their remuneration as incentive-based remuneration. This is also generally the case for non-CEO executives (figure B.4).

For example, at the 20 largest companies in the sample, incentive-based remuneration accounted for over half of the average total remuneration of non-CEO executives. For companies ranked between 100 and 1500 by market capitalisation, incentive-based remuneration accounted for approximately 25–30 per cent of average total remuneration. For the smallest companies (ranked 1500 to 1871), incentive-based remuneration accounted for less than 10 per cent of total remuneration.

Figure B.4 **Structure of non-CEO executive average remuneration packages by company size, 2008-09**



Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Remuneration and company size

Chapter 3 included graphical and statistical evidence of the positive relationship between remuneration and company size. This section goes into further detail on the techniques used to derive that evidence.

Data underlying the graphs of remuneration and company size

Chapter 3 included a graph of the remuneration of CEOs and non-CEO executives in 2007-08 ranked in market capitalisation groups. The following process was followed to generate those data (tables B.8 and B.9):

- Each company in the Financial Review Executive Salary Database was assigned a rank, based on its market capitalisation. The largest company in the sample was ranked 1, and the smallest was assigned a rank of 242–261 (depending on the number of companies for which data were available each year).
- The companies were then divided into groups according to their ranks. The 100 largest companies were divided into groups of 20, and the remaining companies into three groups: 101–150, 151–200, and 201 to the lowest ranked company in the sample.
- In addition to these data, the remuneration of executives outside the ASX300 was plotted using data from the Commission's random sample of companies outside the ASX300.
- The number of CEOs in each group is typically smaller than the number of companies in the group. The reason for this is that some executives were excluded from the sample because they did not serve a full year, or because no CEO could be identified for a particular company in a given year.
  – For example, in 2007-08, there were 19 CEOs in the '1 to 20' group. Gail Kelly, the CEO of the Westpac Banking Group — one of the 20 largest companies by market capitalisation — was excluded from the sample because she did not serve the full year (she commenced on 1 February 2008).

The data clearly show a positive relationship between company size and executive remuneration for ASX300 company executives for every year over the period 2003-04 to 2008-09. This relationship is evident for CEOs (table B.8) and non-CEO executives (table B.9).

Table B.8 **CEO average nominal remuneration by company size, 2003-04 to 2008-09**

Company rank (by market capitalisation)	*Base salary*	*Base total*	*STI*[a]	*LTI*[b]	*Total remuneration*	*Number of observations*
2003-04	$'000	$'000	$'000	$'000	$'000	No.
1 to 20	1 648	3 194	2 210	642	5 629	19
21 to 40	1 116	2 046	1 416	525	3 462	19
41 to 60	947	1 411	1 086	196	2 497	19
61 to 80	736	1 185	300	108	1 530	19
81 to 100	599	899	322	208	1 265	19
101 to 150	514	697	254	79	958	48
151 to 200	355	618	55	106	673	46
201 to 253	370	649	72	122	730	47
2004-05						
1 to 20	1 781	2 274	3 559	1423	7 256	19
21 to 40	1 161	1 576	921	644	3 140	19
41 to 60	1 143	1 667	1 021	591	3 217	17
61 to 80	893	1 376	1 239	272	2 888	18
81 to 100	838	966	431	309	1 706	18
101 to 150	583	697	292	192	1 181	47
151 to 200	417	495	122	102	720	44
201 to 261	380	451	54	132	637	46
2005-06						
1 to 20	1 814	2 503	2 833	1 810	7 145	19
21 to 40	1 370	1 634	1 069	680	3 384	19
41 to 60	816	1 025	1 242	662	2 929	19
61 to 80	810	1 043	618	512	2 173	16
81 to 100	856	929	109	228	1 266	19
101 to 150	615	699	495	290	1 484	47
151 to 200	439	528	147	160	834	47
201 to 259	400	483	129	106	719	47
2006-07						
1 to 20	2 215	3 112	4 300	2 299	9 711	19
21 to 40	1 225	1 414	1 773	852	4 040	19
41 to 60	1 354	2 221	1 100	1 755	5 076	16
61 to 80	1 159	1 342	764	824	2 930	19
81 to 100	775	908	750	563	2 221	16
101 to 150	673	765	381	506	1 653	39
151 to 200	506	614	457	263	1 335	42
201 to 242	450	516	321	201	1 038	39
2007-08						
1 to 20	2 313	2 645	4 508	2 216	9 368	19
21 to 40	1 488	2 714	1 065	1 371	5 150	18
41 to 60	1 307	1 513	1 068	1 420	4 001	18
61 to 80	1 201	2 120	947	1 323	4 389	20
81 to 100	832	962	476	512	1 950	18
101 to 150	858	1 109	616	775	2 499	45
151 to 200	561	644	208	244	1 096	48
201 to 256	475	582	177	177	1 044	47

(Continued next page)

Table B.8 (continued)

Company rank (by market capitalisation)	Base salary	Base total	STI[a]	LTI[b]	Total remuneration	Number of observations
2008-09						
1 to 20	2 461	3 101	2 223	1 869	7 193	19
21 to 40	1 796	2 021	1 332	1 377	4 729	19
41 to 60	1 332	1 597	799	964	3 360	16
61 to 80	1 266	1 690	909	883	3 481	18
81 to 100	819	964	329	523	1 816	19
101 to 150	800	1 007	290	305	1 602	44
151 to 200	654	734	188	268	1 190	43
201 to 260	433	481	188	150	820	49

[a] Short-term incentive. [b] Long-term incentive.

Sources: Financial Review Executive Salary Database; FinAnalysis; Productivity Commission estimates.

Table B.9 **Non-CEO executive average nominal remuneration by company size, 2003-04 to 2008-09**

Company rank (by market capitalisation)	Base salary	Base total	STI[a]	LTI[b]	Total remuneration	Number of observations
2003-04	$'000	$'000	$'000	$'000	$'000	No.
1 to 20	916	1 562	707	415	2 362	90
21 to 40	529	832	637	135	1 475	93
41 to 60	454	665	284	141	1 022	92
61 to 80	338	1 002	138	31	919	80
81 to 100	293	407	100	42	509	94
101 to 150	293	421	89	26	510	203
151 to 200	211	306	38	35	344	204
201 to 253	176	251	32	31	283	206
2004-05						
1 to 20	956	1 343	1 828	543	3 729	89
21 to 40	547	729	302	219	1 250	74
41 to 60	599	764	317	199	1 279	76
61 to 80	404	613	546	106	1 265	92
81 to 100	345	449	117	72	638	90
101 to 150	266	334	117	49	500	224
151 to 200	253	300	51	35	385	202
201 to 261	199	241	30	28	299	231
2005-06						
1 to 20	819	1 157	1 412	639	3 208	120
21 to 40	522	659	357	206	1 223	99
41 to 60	459	531	732	294	1 556	101
61 to 80	370	485	221	79	784	85
81 to 100	352	428	193	124	745	97
101 to 150	285	346	103	64	513	218
151 to 200	247	302	52	55	409	231
201 to 259	219	260	40	33	333	232

(Continued next page)

Table B.9 (continued)

Company rank (by market capitalisation)	Base salary	Base total	STI[a]	LTI[b]	Total remuneration	Number of observations
2006-07						
1 to 20	900	1 233	1 575	1 075	3 882	127
21 to 40	539	712	1 041	378	2 131	120
41 to 60	473	688	268	235	1 191	142
61 to 80	480	623	271	243	1 136	117
81 to 100	380	440	277	173	890	91
101 to 150	323	392	139	140	671	208
151 to 200	254	306	84	64	454	206
201 to 242	246	309	81	183	573	163
2007-08						
1 to 20	898	1151	1 483	998	3 632	138
21 to 40	552	703	324	348	1 375	141
41 to 60	484	596	290	307	1 192	136
61 to 80	410	503	382	563	1 448	152
81 to 100	335	389	145	98	631	114
101 to 150	332	407	156	162	725	292
151 to 200	259	307	57	60	423	274
201 to 256	226	260	58	92	410	296
2008-09						
1 to 20	942	1 320	875	758	2 953	124
21 to 40	678	827	327	298	1 452	125
41 to 60	517	643	211	235	1 089	129
61 to 80	518	609	164	227	1 000	104
81 to 100	370	468	120	350	938	92
101 to 150	339	401	96	79	576	244
151 to 200	305	360	73	63	495	231
201 to 256	267	304	67	67	438	225

[a] Short-term incentive. [b] Long-term incentive.

Sources: Financial Review Executive Salary Database; FinAnalysis; Productivity Commission estimates.

Econometric analysis of the relationship between company size and executive remuneration

Chapter 4 included some evidence of the elasticity of executive remuneration with respect to company market capitalisation. This section describes the econometric technique that was used to derive the estimates for CEOs and non-CEO executives.

The elasticity of remuneration with respect to company size is a measure of how executive remuneration varies according to company size. It describes the average effect of a given increase in company size on the level of executive remuneration. A number of studies have attempted to estimate the elasticity of remuneration with respect to company size, both in Australia and overseas (appendix D). For example, Merhebi et al. (2006) estimated that the elasticity of CEO remuneration with respect to company size (using company revenue as a proxy for size) was 0.27. This implies that for every 10 per cent increase in the revenue of a company, the remuneration of a CEO in the sample increased by, on average, 2.7 per cent.

The Commission carried out some simple linear regression analysis of executive remuneration in Australia using a similar approach to Merhebi et al. (2006).

The model

To estimate the elasticity of remuneration with respect to company size (using market capitalisation as a proxy for size), the Commission estimated the following equation:

$$\log_e (REM_{i,t}) = \alpha + \beta_1 \log_e (SIZE_{i,t}) + \varepsilon_{i,t}$$

where: REM = the total remuneration of an executive

SIZE = the size of the company, proxied by its market capitalisation

ε = error term

Subscripts *i* and *t* denote the company that employs the executive, and the year in which they were employed.

In this context, the estimated value of the coefficient β_1 can be interpreted as the elasticity of remuneration with respect to market capitalisation.

The data

The data on executive remuneration and market capitalisation were drawn from the Financial Review Executive Salary Database. The model was estimated using observations from 2003-04 to 2008-09 for CEOs and 2003-04 to 2007-08 for non-CEO executives. Remuneration and market capitalisation were both deflated using the GDP implicit price deflator.

Results

The results of the estimation show that market capitalisation has a statistically significant positive relationship with the remuneration of CEOs and non-CEO executives (table B.10). The results imply that:

- each 10 per cent increment in market capitalisation is associated with:
  - a 4.2 per cent increment in average CEO total remuneration
  - a 3.8 per cent increment in average non-CEO executive total remuneration
- variation in market capitalisation explains approximately:
  - 28 per cent of variation in average CEO total remuneration
  - 49 per cent of variation in average non-CEO executive total remuneration.

Table B.10 **Estimated elasticity of executive remuneration with respect to market capitalisation**

	CEOs	*Non-CEO executives*
Intercept	5.29***	5.44***
β_1 (estimated size elasticity coefficient)	0.42***	0.38***
Standard error	0.019	0.005
95 per cent confidence interval		
Lower bound	0.39	0.37
Upper bound	0.46	0.39
Adjusted R^2	0.28	0.49
Observations	1 356	5 576

*** Significant at the 1 per cent level.

Sources: Financial Review Executive Salary Database; FinAnalysis; Productivity Commission estimates.

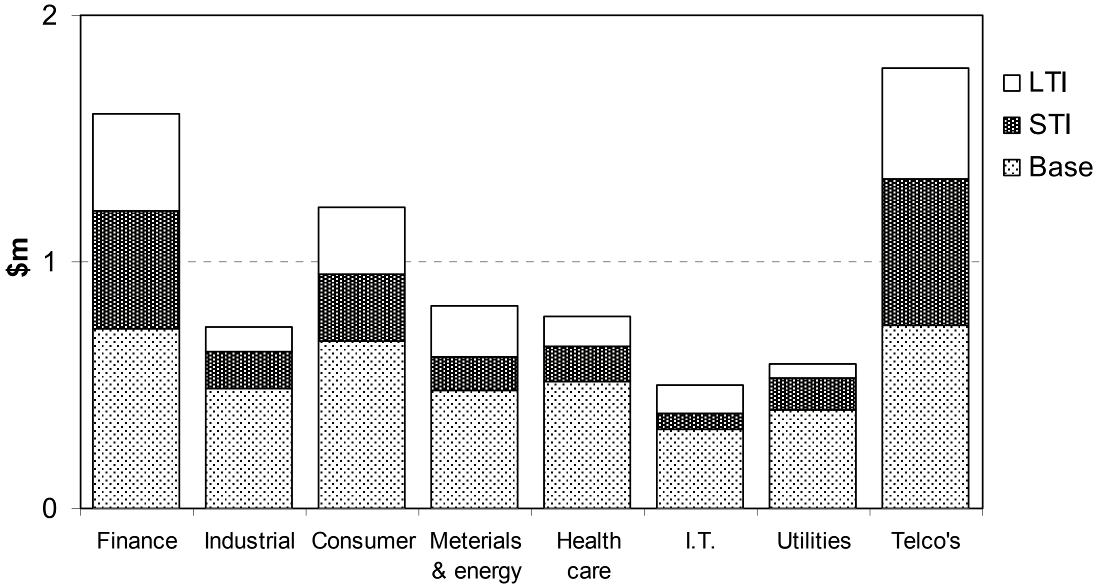
Remuneration and sector — non-CEO executives

As is the case with CEOs, the quantum and structure of remuneration packages paid to non-CEO executives varies across sectors (figure B.5, tables B.11–B.13). Key trends are that:

- as is the case with CEOs, non-CEO executive remuneration is highest in the telecommunications, finance and consumer sectors, and lowest in the information technology and utilities sectors
- executives in the finance, telecommunications and consumer sectors receive more of their remuneration in the form of incentive-based remuneration than executives in other sectors

- over the period 2003-04 to 2008-09, average total executive remuneration grew fastest in the health care, telecommunications and utilities sectors.

Figure B.5 **Structure of ASX300 company non-CEO executive average total remuneration, 2008-09**



Source: Financial Review Executive Salary Database.

Table B.11 **Average ASX300 company non-CEO executive remuneration by market sector, 2003-04 to 2008-09**

	Average remuneration (2008-09)				*Growth rates (2003-04 to 2008-09)*			
Sector	*Base*[a]	*STI*[b]	*LTI*[c]	*Total*	*Base*[a]	*STI*[b]	*LTI*[c]	*Total*
	$'000	$'000	$'000	$'000	%	%	%	%
Financial	729	481	391	1 601	-34	-5	78	4
Industrial	488	147	101	736	-21	-5	30	-5
Consumer	679	274	267	1 220	-19	-10	185	4
Materials and energy	480	132	208	820	-11	-24	153	15
Health care	513	145	119	776	24	90	57	59
Information technology	324	59	117	501	-16	38	158	16
Utilities	402	127	59	589	2	39	97	21
Telecommunications	741	593	455	1 788	-9	69	.. [d]	53

[a] Includes base salary, superannuation and other allowances and benefits. [b] Short-term incentive. [c] Long-term incentive. [d] Growth rate of LTIs cannot be calculated because no LTI was paid in 2003-04. **..** Not applicable.

Sources: ABS (*Australian National Accounts: National Income, Expenditure and Product*, Cat. no. 5206.0); FinAnalysis; Financial Review Executive Salary Database; Productivity Commission estimates.

Table B.12 **CEO average nominal remuneration by sector, 2003-04 to 2008-09**

Sector	*Base salary*	*Base total*	*STI*[a]	*LTI*[b]	*Total remuneration*	*Number of observations*
2003-04	$'000	$'000	$'000	$'000	$'000	No.
Financial	800	1387	906	330	2437	36
Industrial	612	1234	466	144	1700	36
Consumer	877	1302	763	162	2080	51
Materials and energy	589	1051	324	269	1385	67
Health care	476	735	253	97	990	24
Information technology	352	473	105	79	578	14
Utilities	502	730	322	84	1052	7
Telecommunications	476	1128	432	0	1560	3
2004-05						
Financial	753	972	1302	408	2 657	43
Industrial	813	1231	543	419	2 193	35
Consumer	987	1239	940	347	2 526	48
Materials and energy	664	814	382	297	1 493	60
Health care	561	639	300	401	1 340	23
Information technology	406	506	187	66	759	13
Utilities	526	744	267	144	1 155	5
Telecommunications	1 082	1 189	1 076	1 036	3 301	3
2005-06						
Financial	846	1 027	1 650	685	3 362	48
Industrial	801	990	468	428	1 886	33
Consumer	910	1 149	484	500	2 134	46
Materials and energy	661	796	414	363	1 574	78
Health care	604	707	320	376	1 403	19
Information technology	447	664	360	77	1 101	15
Utilities	418	480	243	25	748	8
Telecommunications	1 651	3 095	1 316	160	4 571	2
2006-07						
Financial	1 078	1 327	2 559	1 378	5 264	41
Industrial	901	1 295	648	602	2 545	33
Consumer	1 234	1 622	1 033	535	3 191	38
Materials and energy	694	443	443	546	1 846	73
Health care	684	801	369	832	2 002	16
Information technology	395	435	213	221	870	13
Utilities	960	1 102	675	1 361	3 138	5
Telecommunications	2 987	3 696	5 314	2 772	11 782	1
2007-08						
Financial	1 012	1 314	1 961	1 388	4 663	30
Industrial	1 022	1 173	695	620	2 488	38
Consumer	1 350	2 305	1 051	576	3 931	41
Materials and energy	744	932	456	722	2 111	85
Health care	804	932	439	1 112	2 483	11
Information technology	451	499	177	496	1 173	9
Utilities	464	536	366	400	400	7
Telecommunications	1 886	2 128	3 468	2 454	8 050	2

(Continued next page)

Table B.12 (continued)

Sector	*Base salary*	*Base total*	*STI*[a]	*LTI*[b]	*Total remuneration*	*Number of observations*
2008-09						
Financial	1 298	1 462	1 098	764	3 324	20
Industrial	1 015	1 137	675	342	2 154	42
Consumer	1 387	1 798	766	824	3 388	32
Materials and energy	812	1 038	348	665	2 051	93
Health care	938	1 050	539	484	2 073	12
Information technology	472	520	156	379	1 055	8
Utilities	693	797	383	300	1 479	8
Telecommunications	898	1 041	1 485	564	3 089	3

[a] Short-term incentive. [b] Long-term incentive.

Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Table B.13 **Non-CEO executive average nominal remuneration by sector, 2003-04 to 2008-09**

Sector	*Base salary*	*Base total*	*STI*[a]	*LTI*[b]	*Total remuneration*	*Number of observations*
2003-04	$'000	$'000	$'000	$'000	$'000	No.
Financial	397	911	417	182	1 275	149
Industrial	308	510	127	64	641	167
Consumer	483	695	253	77	969	257
Materials and energy	298	445	142	68	588	297
Health care	223	341	63	63	403	130
Information technology	224	321	35	37	356	69
Utilities	217	327	76	25	403	31
Telecommunications	545	674	289	0	963	8
2004-05						
Financial	441	629	773	195	1 597	140
Industrial	342	462	173	114	748	169
Consumer	447	578	347	71	996	140
Materials and energy	316	414	140	105	663	201
Health care	284	334	96	62	492	94
Information technology	256	289	68	62	419	37
Utilities	220	334	63	67	464	20
Telecommunications	600	691	288	390	1 369	13
2005-06						
Financial	450	547	958	292	1 796	279
Industrial	340	430	165	99	693	22
Consumer	402	526	159	120	805	263
Materials and energy	333	424	142	142	709	331
Health care	321	417	99	80	597	57
Information technology	233	268	104	94	466	159
Utilities	254	312	92	49	453	75
Telecommunications	663	890	636	280	1 807	10

(Continued next page)

Table B.13 (continued)

Sector	Base salary	Base total	STI[a]	LTI[b]	Total remuneration	Number of observations
2006-07						
Financial	498	617	1 083	539	2 240	263
Industrial	405	601	181	163	945	173
Consumer	516	621	337	269	1 227	216
Materials and energy	354	482	170	241	894	372
Health care	352	436	117	167	720	91
Information technology	258	287	102	94	483	58
Utilities	306	421	139	62	622	43
Telecommunications	566	842	655	248	1 745	25
2007-08						
Financial	474	580	827	730	2 136	232
Industrial	390	468	183	162	813	263
Consumer	441	546	289	213	1 047	279
Materials and energy	318	384	110	174	667	510
Health care	351	428	144	187	761	75
Information technology	248	275	80	110	465	57
Utilities	277	314	151	69	534	40
Telecommunications	569	1 022	714	323	2 059	22
2008-09						
Financial	569	729	481	391	1 601	144
Industrial	420	488	147	101	736	265
Consumer	516	679	274	267	1 220	211
Materials and energy	388	480	132	208	820	441
Health care	426	513	145	119	776	67
Information technology	301	324	59	117	501	38
Utilities	358	402	127	59	589	34
Telecommunications	581	741	593	455	1 788	18

[a] Short-term incentive. [b] Long-term incentive.

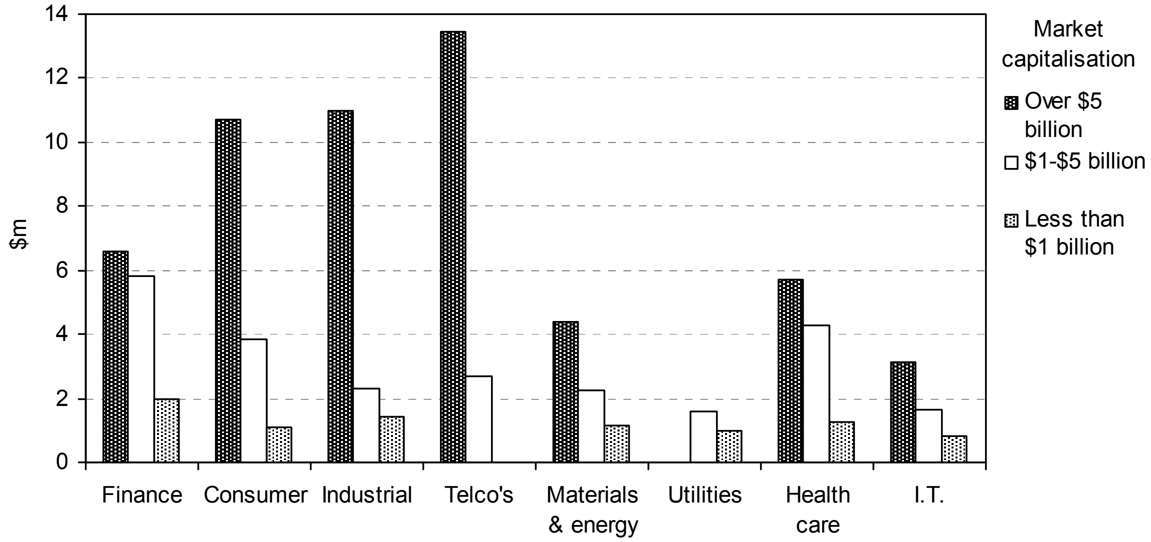
Sources: Financial Review Executive Salary Database; Productivity Commission estimates.

Remuneration varies within sectors according to company size

The positive relationship between executive remuneration and company size is also evident across sectors (figures B.6 and B.7). In most sectors there is a large difference between the average total remuneration of executives at companies with a market capitalisation of over $5 billion and the remuneration of executives of companies with a market capitalisation of between $1 billion and $5 billion. Executives of companies with a market capitalisation of less than $1 billion earn less again. This relationship appears to hold for CEOs and non-CEO executives.

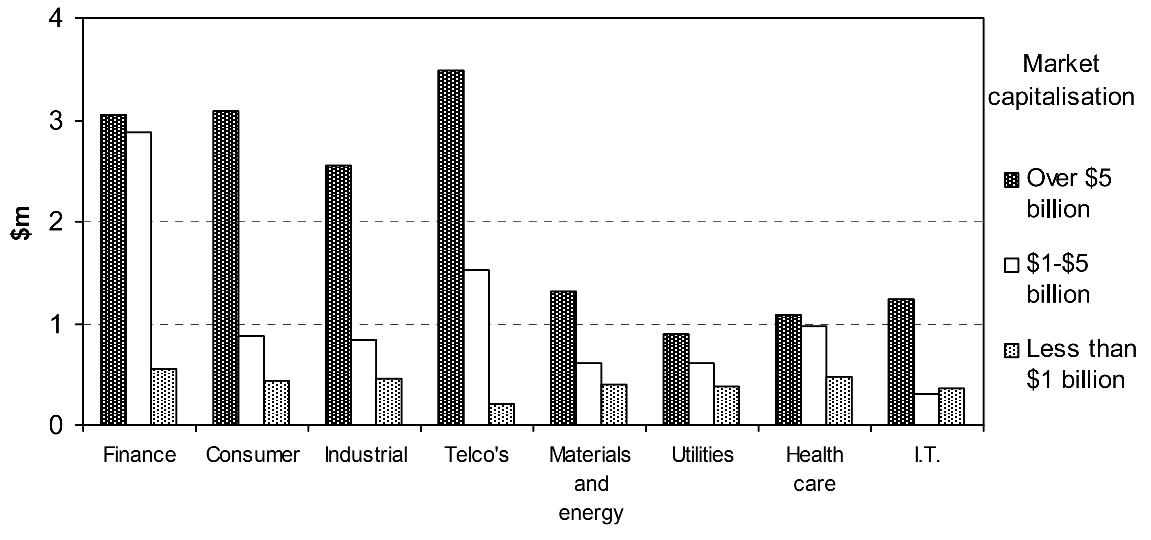
The exceptions appear to be the finance sector, where there is a smaller difference in average remuneration between companies with market capitalisation over $5 billion and companies with a market capitalisation between $1 billion and $5 billion. This is the case for CEOs and non-CEO executives in this sector.

Figure B.6 **Average total remuneration of ASX300 company CEOs, by sector and market capitalisation, 2007-08**



Source: Financial Review Executive Salary Database.

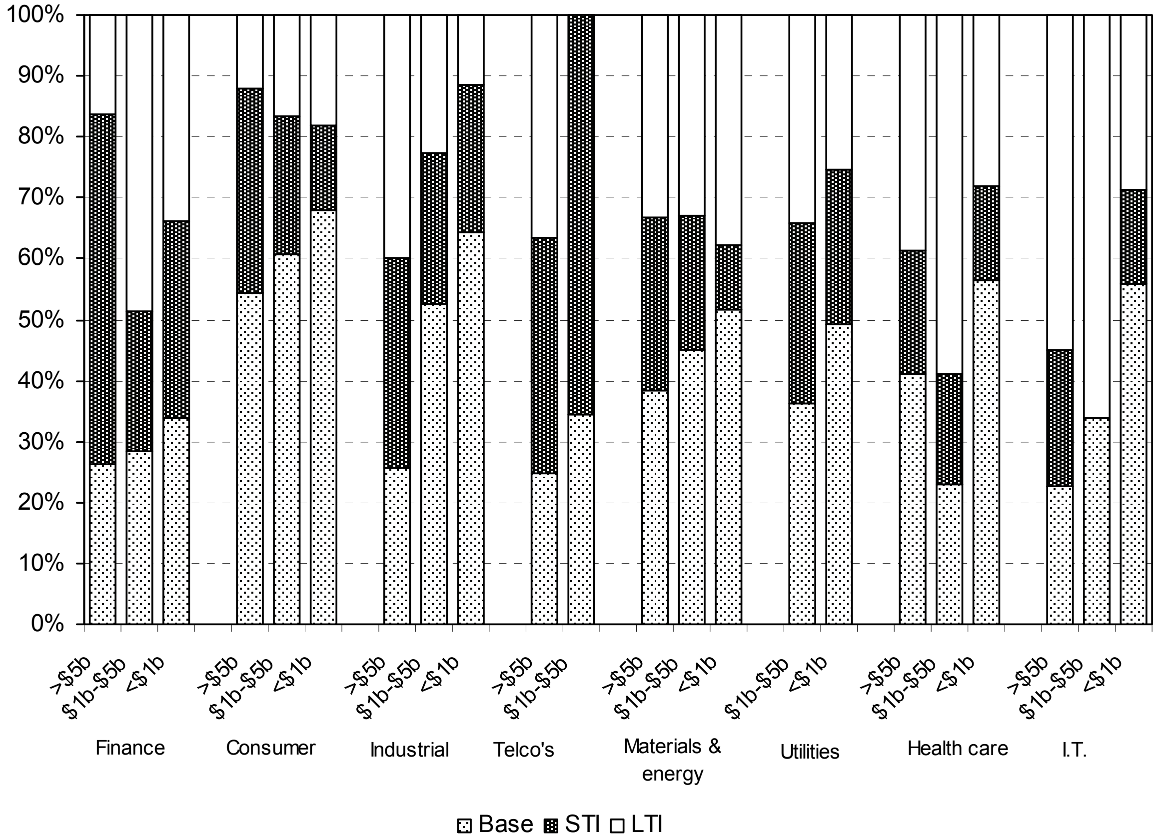
Figure B.7 **Average total remuneration of ASX300 company non-CEO executives, by sector and market capitalisation, 2007-08**



Source: Financial Review Executive Salary Database.

The structure of executive remuneration packages also varies across sectors according to company size (figures B.8 and B.9). Across all sectors in 2007-08, CEO remuneration at larger companies generally included a lower proportion of base remuneration than at smaller companies. This was also the case for non-CEO executives in most sectors, although there are exceptions. Remuneration packages in some sectors included a greater proportion of incentive-based pay than others at all levels. For example, in 2007-08 base remuneration constituted a lower proportion of CEO remuneration at the smallest finance sector companies than at most large and medium-sized companies in other sectors. In general, CEO remuneration included a greater proportion of long-term incentives than non-CEO remuneration.

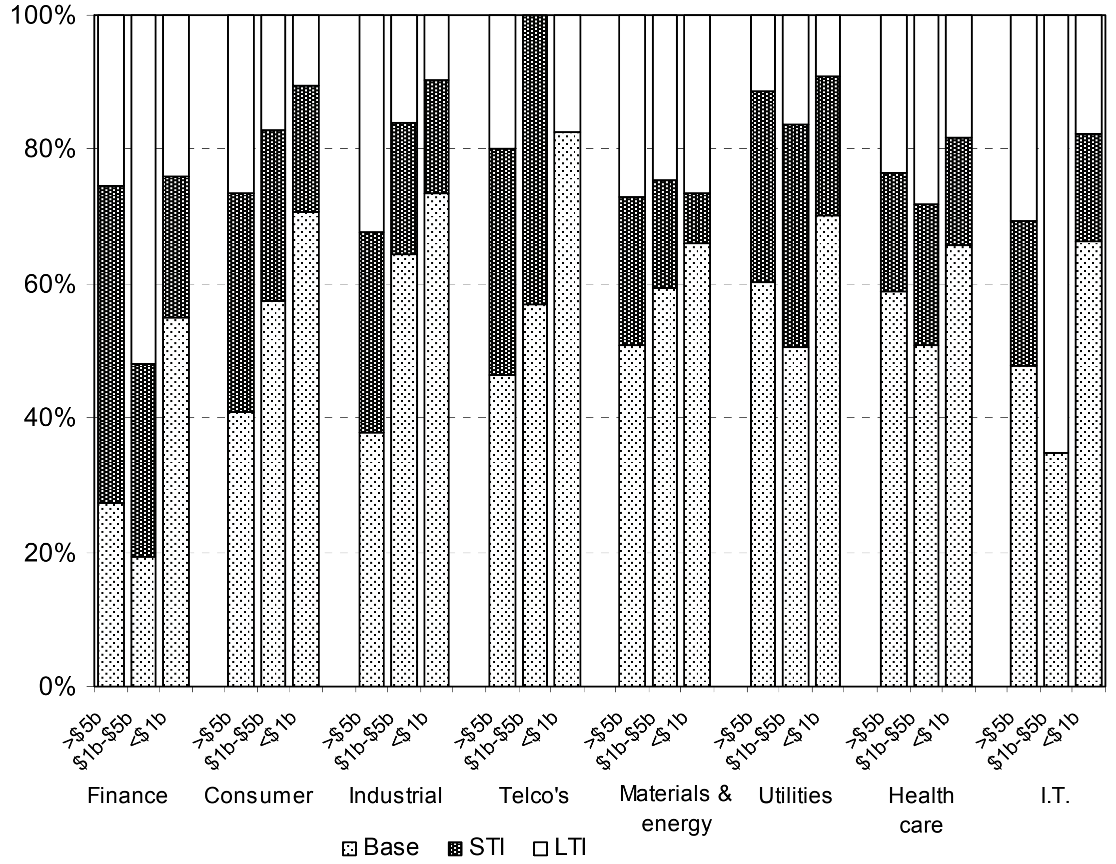
Figure B.8 **Structure of ASX300 CEO average remuneration packages by sector and market capitalisation, 2007-08[a]**



[a] There were no full-year CEOs employed at ASX300 telecommunications companies with a market capitalisation of less than $1 billion. Nor were there any full-year CEOs employed at utilities companies with a market capitalisation of over $5 billion.

Source: Financial Review Executive Salary Database.

Figure B.9 **Structure of ASX300 non-CEO executive average remuneration packages by sector and market capitalisation, 2007-08**



Source: Financial Review Executive Salary Database.

B.3 Further evidence on non-executive directors' remuneration

In general, the remuneration of non-executive directors is relatively straightforward. Directors normally receive a cash fee for their board services, and incentive-based remuneration is uncommon. One complicating factor can be the extra payments that some non-executive directors are granted for service on board committees, such as the remuneration, nomination and audit committees. A sample of ten ASX100 companies demonstrates the wide variation in board committee fees (table B.14).

Table B.14 **Payments to non-executive directors for selected companies[a], 2008**

Company	Fee pool	Base payments for non-executive directors[b] Chair	Director	Payments for service on board committees[b] Chair	Member
	$	$	$	$	$
Alumina	950 000	350 000	140 000	None	None
AMP[c]	3 000 000	550 000	166 000	15 000–127 500	7 500–85 000
Arrow Energy[d]	450 000	107 500	50 000–69 997	Not specified	Not specified
Boral[e]	1 250 000	316 250	115 000	18 750	12 500
Commonwealth Bank[f]	3 000 000	650 000	210 000	10 000–50 000	10 000–25 000
ConnectEast Group[d, e, g]	Not specified	210 000	100 000–112 500	Not specified	Not specified
Metcash	1 000 000	200 000[h]	100 000	20 000–25 000	10 000
Suncorp-Metway[c, i]	3 500 000	550 000	220 000	20 000–30 000	10 000–20 000
Transurban Group[d]	2 100 000	385 000	110 000–165 000	Not specified	Not specified
WorleyParsons[e, j]	1 750 000	437 500	175 000	20 000–35 000	12 000–17 500

[a] These 10 companies were randomly selected from the ASX100. [b] Excludes superannuation, unless otherwise noted. [c] 'Board committees' include boards of subsidiary companies. [d] Reported directors' fees are likely to include membership of board committees. However, no breakdown of figures is provided in the company's annual report. [e] Figures provided for individual payments inclusive of superannuation contributions. [f] The chair of the Commonwealth Bank's 'board performance and renewal' committee receives the same fee payment as the committee's other members ($10 000). [g] Not all non-executive directors of ConnectEast are paid by the group due to its ownership structure, as some directors serve on behalf of (and are paid by) other companies (Macquarie Group, Thiess and John Holland). [h] The Deputy Chair of Metcash received $150 000. [i] Directors' fees at Suncorp-Metway include membership of either the risk or audit committees. Hence reported board committee fees are relevant only for service on the remuneration committee or on the boards of the company's New Zealand subsidiaries. [j] WorleyParsons' directors are not paid additional fees for serving on the nomination committee (either as a member or as a committee chair).

Sources: Company annual reports.

B.4 Further evidence on remuneration and corporate performance

As part its analysis of the relationship between remuneration and corporate performance, the Commission used regression analysis to estimate some statistical models of the relationship. The analytical approach extended the modelling framework used to estimate the relationship between remuneration and market capitalisation (as described above). The approach taken was comparable with several other analyses of remuneration, including Merhebi et al. (2006) and Rankin (2007).

The model

The model estimated was a linear model of the relationship between various types of remuneration and a set of variables that were hypothesised to be related to remuneration. The model specification was:

$$REM_{i,t} = \alpha + \beta_1 SIZE_{i,t} + \beta_2 PERFORMANCE_{i,t} + \varepsilon_{i,t}$$

where: REM = a measure of the remuneration of an executive

SIZE = the size of the company, proxied by the natural logarithm of its market capitalisation

PERFORMANCE = a vector of accounting-based and market-based variables relating to the performance of the company

ε = error term

Subscripts *i* and *t* denote the company that employs the executive, and the year in which they were employed

Data and variables

The model was estimated for CEOs using data from 2003-04 to 2007-08. Only CEOs who had served a full year were included in the sample.

Six measures of remuneration were used to determine whether there was a relationship between corporate performance and the level of remuneration, or between corporate performance and the proportion of total remuneration that was paid as incentive-based remuneration. Remuneration variables were:

- the natural logarithms of base salary, short- and long-term incentives and total remuneration
- the value of short-term incentives as a proportion of base salary (calculated as short-term incentives divided by base salary)
- the estimated value of long-term incentives as a proportion of base salary (calculated as long-term incentives divided by base salary)

- the value of all incentive-based remuneration as a proportion of base salary (calculated as short-term plus long-term incentives divided by base salary).

Indicators of corporate performance that were included in the vector of performance variables included accounting and market-based measures of performance. The indicators that were included in the analysis were:

- total shareholder return for the company's stock (incorporating capital growth and dividends)
- return on equity
- growth of net profit after tax over the previous year.

The model was estimated with performance indicators for the current year, and lagged one and two years. Lagged variables were incorporated to capture the possible effects of historical performance on the level and structure of executive remuneration.

Results

Results of the estimation are reported in table B.15. In most cases, there is no statistically significant relationship between indicators of corporate performance and various measures of CEO remuneration. However, the model does yield some statistically significant results, including:

- Higher total shareholder return in the current year is associated with lower remuneration in several cases. However, higher shareholder returns in the previous year are associated with higher remuneration in some cases (particularly with higher long-term incentives).
- The growth of net profits (whether in the current year or when lagged one year) has a statistically significant positive relationship with some measures of short- and long-term incentives. Under one model specification, it has a negative relationship with total remuneration.
- Return on equity has a statistically significant positive relationship with long-term incentives.

Table B.15 **Regression results — CEO remuneration and corporate performance, 2003-04 to 2007-08**

	Corporate performance indicators											
Remuneration variable	*Intercept*	*Log market cap$_t$*	*TSR$_t$*	*NPAT growth$_t$*	*ROE$_t$*	*TSR$_{t-1}$*	*NPAT growth$_{t-1}$*	*ROE$_{t-1}$*	*TSR$_{t-2}$*	*NPAT growth$_{t-2}$*	*ROE$_{t-2}$*	*R^2*
Log base salary	7.842***	0.259***										0.12
	7.382***	0.285***	-0.089*	-0.001	-0.078							0.15
	7.477***	0.282***	-0.127**	-0.012	-0.067	0.005	-0.004	0.034				0.16
	7.520***	0.281***	-0.160**	-0.011	-0.067	-0.014	-0.011	0.095	0.000	-0.008	-0.173	0.15
Log STI[a]	1.756***	0.528***										0.40
	0.931*	0.573***	-0.100*	0.016**	-0.522							0.47
	0.905*	0.575***	-0.098	-0.007	-0.219	0.053	0.001	-0.569				0.46
	0.919	0.576***	-0.110	-0.005	-0.061	-0.011	-0.003	-0.589	-0.009	0.002	-0.150	0.47
Log LTI[b]	2.948***	0.459***										0.25
	1.223	0.541***	-0.344***	-0.012	0.217*							0.36
	0.817	0.557***	-0.424***	-0.002	0.196*	0.083**	0.006	0.363				0.38
	0.783	0.560***	-0.482***	0.000	0.197*	0.052	0.047**	0.220	0.001	-0.017	-0.104	0.38
Log total remuneration	5.844***	0.391***										0.19
	4.570***	0.455***	-0.114**	-0.002	-0.059							0.25
	4.428***	0.462***	-0.162**	-0.017*	-0.053	0.044	0.008	-0.040				0.28
	4.322***	0.467***	-0.205***	-0.015	-0.055	0.025	0.028	-0.072	-0.006	0.001	0.020	0.27
STI[a]/base salary	-6.637***	0.360***										0.04
	-8.316***	0.441***	-0.036	0.021	-0.052							0.04
	-8.387***	0.446***	-0.024	-0.006	-0.022	0.032	0.011	-0.750				0.12
	-8.860***	0.461***	-0.024	-0.005	0.011	0.039	-0.001	-1.248	-0.016	0.068***	1.106	0.05
LTI[b]/base salary	-0.476	0.054										0.00
	-2.762***	0.156***	-0.072	-0.004	0.008							0.06
	-3.516***	0.188***	-0.087	-0.005	-0.013	0.137***	0.014*	0.060				0.10
	-3.687***	0.195***	-0.113*	-0.003	-0.016	0.196***	0.025	-0.069	0.012	0.013	0.115	0.11

* Significant at the 10 per cent level. ** Significant at the 5 per cent level. *** Significant at the 1 per cent level. [a] Short-term incentives. [b] Long-term incentives.

Sources: Financial Review Executive Salary Database; FinAnalysis; Productivity Commission estimates.

Analysis of the value of the coefficient of determination (R^2) under different model specifications gives an indication of the extent to which the performance indicators increase the explanatory power of the models. The results suggest that:

- the single most significant factor in explaining the quantum of remuneration over the period under analysis is market capitalisation
- adding performance indicators to the model does not significantly increase its power to explain variations in base salary
- adding performance indicators for the current year does slightly increase the power of the model to explain variation in short- and long-term incentives and total remuneration.

Adding performance indicators lagged one year increases the ability of the models to explain variation in the proportion of remuneration that consists of incentives.

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