SUBMISSION

TO

THE PRODUCTIVITY COMMISSION

INTO THEIR

INQUIRY INTO REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION IN AUSTRALIA

BY

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I will start by addressing the contrasting views stated on page 4 of the Issue Paper.

1. **There is a limited pool of talented and mobile executives.** Surely this cannot be true. In Australia there are certainly more than the required number of talented individuals who can work as CEO's of Australian public companies. It is possible that many of these talented individuals may not have been working in the capacity of a CEO but that does not mean that they do not possess the necessary knowledge and skills required to be successful CEO's. Australia has excellent universities and has been graduating a large number of highly skilled individuals who with experience and further training can transform themselves into successful CEO's. There are many instances of Australians working as CEO's overseas and doing an excellent job. In the vast majority of cases there seems to be no valid reason for Australian businesses to search overseas to find CEO's. Under exceptional circumstances, which would probably arise when the business is highly specialized and the CEO needs to be experienced in a specific industry that is new to Australia, should the company find it necessary to search overseas for a CEO. An Australian CEO would understand possess excellent understanding of the local business environment. The Australian CEO would also have the social and emotional ties to Australia and this attachment would be a good enough motivation for the CEO to perform well. Above a certain level of remuneration, prestige and social standing are at least as strong motivating factors for the CEO to do an excellent job. CEO's who do not have long term ties to Australia do not really have the incentive to make that extra effort to make their companies succeed. A recent example is the ex-CEO of Telstra Sol Trujillo. So there is really no need to match executive salaries in Australia with those in USA or Europe. Nobody mentions salaries of Japanese executives probably because they are much more modest and by Japanese standards Australian executive are

already grossly overpaid. The CEO of Toyota, the most successful automobile manufacturer is paid US $ 1 million annually whereas the CEO's of the US car companies were paid about $ 13 million and two of the three manufacturers are bankrupt.

2. **Executives take on a level of risk considerably higher than other employees.** It is possible that the employment contract of the CEO's may require them to meet certain performance criteria but in the vast majority of cases they are extremely well compensated if they are asked to leave due to their failure to meet these criteria. So where is the risk. The golden parachutes are so generous that the CEO could retire from full time employment with the money paid for failure. Frankly there is less job security at lower levels than there is for the CEO and there is not even a bronze parachute. With every promotion there is greater risk of getting fired and in actual practice the risk is lower at the CEO level. In spite of the higher risk people not only accept promotion but in fact look upon the promotion as a reward for a job well done. The CEO earns the highest remuneration in the company because the position has the highest level of responsibility and risk. This does not imply that the CEO deserves a huge salary and ridiculously large bonus along with a golden parachute.

3. **Executives in listed companies are subject to intense scrutiny.** What relationship does the level of public scrutiny the executive is subjected to have with the level of public scrutiny. consideration. If the executive can choose to maintain a low profile the level of public scrutiny would be correspondingly low. If there is a direct relationship between the level of public scrutiny and the remuneration, then many executives would prefer a high level of public scrutiny. This claim is patently absurd and does not merit any consideration. There are many self-effacing and modest CEO's who are not subject to intense public scrutiny and who are more likely to perform much better than their more famous colleagues.

4. **Executive remuneration increases broadly with market capitalization and returns to shareholders.** There are no reported cases of reduction in executive remuneration with reduction in market capitalization or shareholder returns. In any case executive remuneration has no connection with a company's market capitalization or shareholder returns. Executives have absolutely no control over the outcome of any their decisions or actions in relation to market capitalization or shareholder returns. Executives only have control over their efforts to achieve desired outcomes. This crisis has clearly proved beyond any reasonable doubt that no human can guarantee such an outcome. Since the executive cannot guarantee the market capitalization of the company, the executive cannot claim any credit for any increase in the market capitalization and cannot be held responsible for any reduction in the market capitalization.

The same argument holds for shareholder returns. So just for making efforts to achieve certain share market outcomes does not qualify as a reason for huge pay packets. From the viewpoint of the business, the employees, customers and society in general it is preferable to manage a business with a long term perspective than trying to meet the quarterly earnings of financial analysts. In any case most financial analyst's expectations of quarterly earnings are derived from statements made by the company's management. There is also the mistaken belief that the business should be managed to with the sole objective of enhancing shareholder value and the only way to do so is to ensure an increase in the market capitalization of the company. Even Jack Welch, the former CEO of GE who did so much to popularize this concept, now says that increase in shareholder value is the result of good management and the company should be managed to serve its customers, employees and the society in which it operates.

5. **Corporate excesses are mainly a foreign phenomenon.** There are so many instances of outsize pay packets in Australia. Telstra, Macquarie Group, Banks, Allco Finance, Babcock & Brown, ABC Learning etc. I really wish this was so but unfortunately it is increasingly obvious that we Australians are very quick to follow some of the worst practices prevalent in USA & UK. We slavishly follow the Anglo-US model. It is almost as if it is a part of our character.

In their groundbreaking study "Leadership and Organizational Performance: A Study of Large Corporations" first published in 1972 in American Sociological Review, Stanley Lieberson and James O'Connor argued that:

- CEO's influence is seldom decisive in a company's performance
- "Industry effects" such as the amount of available capital and the stability of the market accounted for almost 30% of the variance in corporate profits
- "Company effects" such as the firm's historical place in the corporate pecking order explained about 23%
- "CEO effects" explained just 14.5% and even this impact, it was felt, should be viewed skeptically: it unavoidably bundles CEO actions that were genuinely smart and skillful with those that were merely lucky

Other scholars have found that the CEO effect is even smaller, somewhere between 4.5 percent to 12.8 percent.

In an article entitled "Do CEO's Matter" in the June 2009 issue The Next American Dream Harris Collingwood has argued that "an exalted view of the boss is supported by a cottage industry of management gurus and executive-compensation consultants. They have good reason to sell boards of directors, investors, journalists and CEO's themselves on the notion that the chief

executive is inordinately valuable. Management gurus win new assignment through referrals from grateful clients, and they can expect no thanks for tetlling the CEO he's just another cog in the machine. Compensation consultants know that if they win big pay packages for their CEO clients, they'll be rewarded with lucrative contracts to administer employee benefit plans and the like."

In the recently published The Truth About Middle Managers by Paul Osterman of the MIT Sloan School of Management, he contends that the large corporation's rise to social and economic dominance depends on middle managers because it just isn't possible to achieve the scale that has been achieved without the middle managers doing the kind of planning work they do. He finds that middle managers value their task, sense its importance to the larger cause, and feel great loyalty to the people they work with but their loyalty to the corporation is fraying because they see that top management gets all the rewards and glory. Three Harvard professors Noam Wasserman, Bharat Anand and Nitin Nohria in a recent paper write "It is worth noting here that a large CEO effect need not imply a positive impact."

In the May 2006 issue of Stanford Business Magazine, Jeffrey Pfeffer and Robert Sutton write that "Managers often have far less influence over performance than most people think." Pfeffer's 1977 review of research on leadership "found that although leaders do have some impact, their actions rarely explain more than 10 percent of the differences in performance between the best and the worst organizations and teams. In the same paper, the authors write that "more recent studies confirm that the link between leadership and performance is modest. Studies of leaders from large samples of CEO's in public companies to university presidents to managers of college and professional sports teams show that organizational performance is determined largely by factors that no individual – including the leader - can control. Even the most powerful executives have little influence over macroeconomic trends, the price of international currency and oil, wars and terrorism, organizational history, and the weather." They further relate part of a discussion they had with a former GE executive Spencer Clark who led a large business group during Jack Welch's reign. They write "Clark joked," Jack did a good job, but everyone seems to forget that the company had been around for over a hundred years before he ever took the job, and he had 70,000 other people to help him." They further write "An important reason leaders get too much credit or blame for what goes on boils down to money, power, and prestige. Leaders have enormous incentives for perpetuating the myth that they are in control." When the authors asked any organizational leader in the private or public sector "Do you have as much power, control, or influence as you think you need over your organization? And the answer is almost invariably "no." the leaders themselves, living and managing as best they can, recognize all too well the limits on their ability to make things happen." The authors also write "Despite evidence to the contrary, boards of directors, search committees of all stripes, human resource management departments, and just about anyone who completes performance evaluations will likely succumb to the belief that leaders

are in control and ought to be. So they hire, praise, hold on to, and promote leaders who seem to be in control of events."

In the October 20, 2006 issue of Fortune magazine, Justin Fox writes "you cant really judge a CEO's tenure until years after he has left office." He quotes Jim Collins in the book "Good to Great" in which he identified 11 CEO's who steered their corporations to sustained leaps in stock performance and found that they were all self-effacing insiders who put their companies ahead of themselves and focused most of their early efforts on surrounding themselves with good people. Fox states that there is now "recognition that long-term success is often built upon less tangible factors like employee motivation and customer satisfaction." He quotes Stanford Business School professor Jeffrey Pfeffer "Good leaders can make a small positive difference; bad leaders can make a huge negative difference – because they drive people out. If you said to me, 'Who can fix GM?' I don't know. But there's no question that someone could make an enormous difference on the downside." He further writes "The ultimate lesson here may be that there are limited rewards to identifying the very best CEOs. Same with paying CEOs like superstars – Collins found no clear link between executive pay and success at the "good to great' companies he studied."

Eliot Spitzer, the previous Attorney General of New York State, in an article in Slate magazine dated April 15, 2009, entitled "Judge Posner Wrote What?" had this to say about excessive executive compensation – "Richard Posner, esteemed federal judge of the 7th Circuit, is one of the most respected and prolific conservative intellectuals. As a founder of the "Chicago School," he is both a creator and defender of the free-market theory that has guided deregulation for the past 30 years." He read an opinion authored by Judge Posner saying that "the market is arguably incapable of either setting CEO compensation or determining mutual fund fees". Justice Posner further wrote that "there are growing indications that CEO compensation is excessive because of the feeble incentives of board of directors to police compensation. Directors are often CEO's of other companies and naturally think that CEO's should be well paid. And often they are picked by the CEO." "He then examined the conflicts inherent in the process of CEO compensation determination, concluding that "competition …can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities". Spitzer added that "Posner also concluded that evidence of unreasonable compensation could be evidence of a breach of fiduciary duty" and also that "courts should take a hard look at private-compensation issues." Spitzer found it "remarkable that a leader in Chicago School thought would acknowledge that the market is so broken that it can't be properly trusted on" this issue. According to Spitzer "CEO compensation cuts to the ability of our corporate government system to function. In a genuine marketplace, nothing should be easier than a board, assisted by compensation consultants, a bevy of lawyers, and of course, shareholders, setting the salary of one person. Yet this simple task is now deemed by one of the most articulate defenders of the free market to be beyond the competence of

the market.” Spitzer recommends that it is time for boards, compensation consultants and shareholders to awaken to their duties and to insist on far greater transparency and far stricter evaluation of CEO’s and eliminate the year-end congratulatory assessments that seem unconnected to any economic reality.

Eliot Spitzer in another article in the 19th February 2009 issue of Slate magazine has provided some suggestions about dealing with this issue. He writes that “fixing the compensation debacle will require addressing the behavior of three groups: compensation consultants hired by the boards, compensation committees, and most importantly institutional shareholders. These groups must rise up and reclaim power from a system that is now dominated by CEO’s. Its clear that the shareholders must have the final say and this means that the shareholder vote on CEO compensation must be binding. Spitzer believes that the compensation consultants show greater allegiance to the CEO than to shareholders. To address this conflict, Spitzer suggests creating a special shareholder committee to select the compensation consultant and to require these consultants to be stand-alone companies without any possible ancillary business relationships with the company that hires them. Spitzer writes that under such an arrangement the “CEOs would be paid like other workers – for doing their jobs and fulfilling their fiduciary duties. They wouldn’t be paid for the illusory concern that the company would collapse in their absence. Most compensation negotiations begin with the premise that the particular CEO is irreplaceable. But as de Gaulle wryly observed, the graveyards are filled with indispensable people.” Spitzer also recommends a simple rule relating to compensation committees. He believes that “those who participate must be totally independent of the CEO. No conflicts, direct or indirect, should be permitted. They must have no other common board memberships, no overlapping charitable causes, no shared social clubs. Nor should compensation committee members be CEO’s or executives of any rank whose own pay will in any way be measured against the pay of the individual whose pay they are setting. Most importantly, shareholders should vote directly on the constituency of compensation committees. It has become all too easy for boards to give away “other people’s money” without having to answer to shareholders. Shareholders should vote every member on or off the committee and be able to propose members directly, while the CEO should have no role whatsoever in proposing membership of the committee.” Spitzer recommends a simple proposal: “Make senior executive pay a matter of shareholder vote. Not the “non-binding” votes that are all the rage. Make them subject to a real up-or-down vote. Give shareholders power again. Force executives to appear in front of their employers and explain why they deserve the package they are offered.” Considering Eliot Spitzer as Attorney General of New York state was the first official to take on the biggest Wall St. Banks and successfully disciplined them and made them pay more than a billion dollars in fines for fraud, he is vey well aware of how the compensation system works and his recommendations could be successfully enacted into law.

There is a lot more published literature that clearly demonstrates that:

- Nobody is capable to predicting with even a remote degree of certainty any outcome and so CEO's cannot be expected to do so either.
- There is no correlation between CEO compensation and CEO performance.
- The performance of a CEO can really be evaluated only several years after he or she has left the company. So what appears to be successful performance may be found to have been average or even disastrous performance.
- Even in the case of genuinely successful CEO's there is really no guarantee that they will able to reproduce their successes.

For all the above reasons CEO compensation should be:

- Subjected to shareholder vote only and the board should have no say whatsoever
- CEOs should be compensated just like any other employee and should only be entitled to a bonus if every employee is also paid a bonus
- Compensation committees members should meet the criteria recommended by Spitzer and be selected by shareholders