29 May 2009

Freehills

Submission

Regulation of Director and Executive Remuneration in Australia

Executive summary

- Any executive remuneration framework should not create unnecessary regulatory burdens on companies and should be consistent with established corporate law principles.
- Transparency and accountability should be the twin aims of this system.
- Australia's current system governing director and executive remuneration is functioning adequately – relative to peers, Australia has largely avoided the corporate 'excess' and risk-taking behaviours which have contributed to corporate collapses and the economic downturn more generally.
- Current remuneration disclosures could be streamlined and presented more meaningfully for shareholders. This would serve to increase transparency and the accountability of the board to its shareholders in relation to remuneration issues.

Are current remuneration arrangements appropriate?

- Corporate law requires that the board acts in the best interests of the company (and shareholders), including with respect to setting and structuring remuneration.
- Boards need considerable discretion in relation to structuring and setting remuneration as part of their management function.
- Shareholders have oversight of board activities through the remuneration report, and are able to give feedback on the board's performance in this respect through the advisory vote and questions at the annual general meeting.
- As a last resort, shareholders can also vote down directors at elections, requisition meetings, circulate statements, propose resolutions and remove board members.

Do the current remuneration arrangements lead to undue risk-taking?

- Australia has not seen 'perverse' incentives to the same degree as the US/UK, and has not been required to bail out companies to the same extent as has occurred in other jurisdictions.
- Whilst there are isolated examples of companies adopting remuneration arrangements that have proven inappropriate in the changed economic climate, in general boards have acted in good faith in setting remuneration structures.

1 Introduction

This submission is made to the Productivity Commission (**Commission**) in response to the Issues Paper released on 7 April 2009 as part of its inquiry into the Regulation of Director and Executive Remuneration in Australia.

1.1 What are the key issues before the Commission?

Freehills considers that the regulatory regime governing executive remuneration in Australia should be assessed objectively in terms of the following issues:

- Do the current regulatory arrangements appropriately protect shareholders' interests?
- Are the reporting arrangements appropriately transparent and comprehensible for shareholders?
- Does the current regulatory framework hold boards accountable for the remuneration arrangements which they have adopted?

1.2 What approach should the Commission adopt?

In responding to the global financial crisis, Freehills notes that much of the worldwide focus has been on the financial services sector. Consistent with this trend, the Australian Prudential Regulation Authority (**APRA**) has developed a draft principles-based framework for executive remuneration that will apply to APRA regulated institutions in Australia (**Practice Guide**).[1] Whilst the APRA framework will only have direct application to the financial sector, Freehills anticipates that this framework may over time become a corporate governance benchmark for public companies across all sectors.

Freehills supports principles-based reform which is simple, practical and focused on risk-management. This should be in the form of market guidance or a requirement to report against a non-binding code.

Freehills does not support increased levels of regulation. In particular, Freehills considers that the existing regulatory framework governing executive remuneration in Australia is already complex and imposes significant compliance costs on companies. Freehills is concerned that ad hoc legislation without due regard to the established principles of corporate law could exacerbate the compliance burden and create unintended consequences for companies.

Similarly, Freehills does not support regulation imposing fixed limits or prescribing specific remuneration practices. Such regulation would not be sufficiently flexible to accommodate the broad range of business drivers applying to every Australian company's circumstances. In this respect, Freehills notes the restrictions imposed on remuneration practices by the United States Government as a condition of accepting financial assistance under the Troubled Asset Relief Program and expresses its view that such regulation can place companies at a comparative disadvantage, create disincentives for reforming businesses and restrict long-term change.

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[1] Prudential Practice Guide 511 – Remuneration (released 28 May 2009)

2 Effectiveness of regulatory arrangements (TOR 2)

Company directors are already under legal obligations which apply to their remuneration decisions, including a general obligation to act in the best interests of the company they serve. These obligations safeguard the interests of shareholders and provide avenues to penalise improper discharge of directors' duties in respect of remuneration practices. The imposition of new obligations in respect of executive remuneration risks creating unnecessary duplication, or worse, undermining the current obligations imposed on directors under the law.

2.1 Current regulatory regime

The current regulatory regime governing executive remuneration in Australia reflects the following basic principles:

- the board of directors is responsible for overseeing the management of the corporation, including setting its remuneration practices;
- directors are placed under general law and statutory duties to exercise skill and care in performing this function, and are required to act in the best interests of the company (and by extension, its shareholders);
- through reporting obligations and meeting requirements, directors are held accountable to shareholders in respect of their own pay and that of senior executives, including in relation to the quantum and structure of the remuneration and the adequacy of linkages to the performance of the company;
- shareholders are given certain powers which they can exercise if they consider directors are failing in their duties to the corporation; and
- legislation and market listing rules contain certain specific protections (backed by civil and criminal penalties) to safeguard the interests of shareholders and the broader market.

(a) The role of the board

Under Australia's system of corporate law, the board of directors of a corporation is charged with its management and bears responsibility for its decisions. In practice, it is common for directors to delegate the operational aspects of the business to a dedicated management team.[2] However, ultimately, the board of directors is responsible for overseeing the management of the corporation.

Importantly, the board's responsibility for the management of the company extends to the remuneration of its executives and employees.

In approaching remuneration decisions, the board must weigh up a myriad of competing concerns, including:

- the financial position and business drivers of the corporation;
- the corporation's capacity to attract qualified and competent executives (especially in specialised industries, new start-up businesses and companies with global operations) as compared to its competitors;
- the corporation's resourcing requirements and the required timing for the supply of executive services;
- costs associated with locating external candidates vs. re-deploying internal candidates;
- creating incentives for executives to increase performance/production or, alternatively, for them to identify opportunities to minimise costs; and
- the need to retain certain 'key' executives (especially those engaged on important projects).

[2] Note that the scope of the directors' legal obligations ensures that the directors, while able to reasonably rely on advice from others, are still required to exercise their own independent judgement in performing their duties.

(b) Legal obligations of directors

The principal instrument regulating directors and officers of Australian corporations is the *Corporations Act 2001* (**Corporations Act)**. Under s180(1) of the Corporations Act, 'director[s] or other officer[s] of a corporation' are placed under a duty of care and diligence, and must 'exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise' in their circumstances. The Act also imposes duties of good faith[3] and loyalty.[4]

Each of the statutory duties is a 'civil penalty provision'. A breach of such a provision may result in a court order requiring the payment of a penalty of up to $200,000 if the contravention is 'serious' or materially prejudices the interests of the company or its members or the company's ability to pay its creditors.[5]

Further, a director will commit an offence punishable by a penalty of up to $220,000 or imprisonment for 5 years (or both) if, broadly, a breach of section 180(1)(2) or (3) is committed recklessly or dishonestly (or both).[6]

Directors are in also in a fiduciary relationship with the company. This stems from the obligation of directors to use their powers for the benefit of the company and not for themselves. Fiduciaries are not allowed to put themselves in a position where their personal interests and duties conflict.[7]

Directors owe these duties to the company. This usually equates to acting in the best interests of the shareholders (unless the company is approaching insolvency, in which case the interests of creditors must also be considered).[8]

Accordingly, in approaching employment negotiations with executives (or re-negotiating the terms of existing executives' employment), the board is always subject to overriding legal obligations to act in the best interests of the company (and shareholders) in setting and structuring remuneration.

(c) Mechanisms to ensure board accountability

The Corporations Act provides a number of key obligations on the board to report to its shareholders in respect of the management of the corporation, including:

- the requirement for public companies (and certain other entities) to produce an annual report, including a directors' report each financial year;[9]
- the requirement for public companies to hold an annual general meeting;[10]
- the obligation for the chair of a general meeting to allow a reasonable opportunity for shareholders as a whole to ask questions about, or make comments on, the management of the company;[11] and
- the requirement that the auditor of a listed company attend the annual general meeting,[12] the right of shareholders to ask questions of the auditor at the annual general meeting,[13] and the right of shareholders of listed companies to submit written questions to the auditor.[14]

In addition, the Corporations Act imposes several key obligations on company boards to specifically report to their shareholders in respect of remuneration and to give the

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[3] *Corporations Act 2001 (Cth)*, s181(1).

[4] *Corporations Act 2001 (Cth)*, s182(1), and s183(1).

[5] *Corporations Act 2001 (Cth)*, s1317G.

[6] *Corporations Act 2001 (Cth)*, s184.

[7] Ford H A J, Austin R P and Ramsay I M, *Ford's Principles of Corporations Law* (13th ed, 2007), 338-339.

[8] *Walker v Winborne* (1976) 137 CLR 1.

[9] *Corporations Act 2001 (Cth)*, s292.

[10] *Corporations Act 2001 (Cth)*, s250N.

[11] *Corporations Act 2001 (Cth)*, s250S.

[12] *Corporations Act 2001 (Cth)*, s250RA.

[13] *Corporations Act 2001 (Cth)*, s250T.

[14] *Corporations Act 2001 (Cth)*, s250PA.

shareholders opportunities to comment on the board's conduct in this respect. Key obligations include:

- the requirement for the company to produce a remuneration report detailing the level and form of remuneration paid to its directors and certain senior executives, and explain how its remuneration is linked to company performance;[15]
- the requirement for an advisory vote on the remuneration report at the annual general meeting of the corporation,[16] including the opportunity to ask questions in respect of the remuneration report;[17] and
- the right of shareholders to circulate statements in relation to a proposed resolution or other business to be considered at a general meeting (including the remuneration report).[18]

These provisions ensure that shareholders are provided with sufficient information about the management of the company to assess its remuneration structures for themselves (having regard to the company's operations and performance).

The regulatory regime described above allows shareholders to raise concerns about remuneration arrangements (and a number of other matters) with the board directly at the company's annual general meeting. Shareholders can also express any concerns that they have with remuneration levels or structures by voting against the adoption of the remuneration report.

(d) Mechanisms for shareholder action

As a final resort, where shareholders consider that the board does not have due regard to their interests in setting the company's remuneration arrangements, shareholders can take action to hold the board to account for its actions by removing directors.[19]

This power is facilitated by the following rights given to shareholders under the Corporations Act:

- the right of shareholders to requisition a general meeting of the company;[20]
- the right of shareholders to call a general meeting of the company at their own expense;[21]
- the right of shareholders to apply to the court to convene a general meeting of the company;[22]
- the right of shareholders to requisition a resolution to be put to the general meeting;[23] and
- the right of shareholders to circulate statements in relation to a proposed resolution or other business to be considered at a general meeting (including the remuneration report).[24]

(e) Other specific protections

The Corporations Act also contains other specific protections which are relevant to the protection of shareholder interests. One such example is the prohibition on the payment of a benefit in connection with a person's retirement from a board or managerial office

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[15] *Corporations Act 2001 (Cth)*, s300A. Broadly, the remuneration of the top 5 highly remunerated company and group executives, as well as all of the key management personnel must be disclosed.

[16] *Corporations Act 2001 (Cth)*, s250R(2)

[17] *Corporations Act 2001 (Cth)*, s250SA

[18] *Corporations Act 2001 (Cth)*, s249P.

[19] *Corporations Act 2001 (Cth)*, s203D.

[20] *Corporations Act 2001 (Cth)*, s249D.

[21] *Corporations Act 2001 (Cth)*, s249F.

[22] *Corporations Act 2001 (Cth)*, s249G.

[23] *Corporations Act 2001 (Cth)*, s249N.

[24] *Corporations Act 2001 (Cth)*, s249P.

unless the company obtains shareholder approval or a specific statutory exception applies.[25]

The ASX Listing Rules (**Listing Rules**) also offer several specific protections. Importantly, the Listing Rules require that shareholder approval is sought in respect of equity grants to executive directors where those grants are satisfied by an issue of shares[26], in order to ensure that remuneration to executive directors is not dilutive of shareholder interests and is not on advantageous terms.

The Listing Rules also require that any increase to the total non-executive director fee pool is approved by shareholders[27]. Accordingly, shareholders can vote against any increase in aggregate non-executive directors' fees if they are dissatisfied with the management of the company.

2.2 Are these arrangements effective?

Freehills considers the current regulatory regime governing executive remuneration as described above is sufficiently robust to safeguard the interests of Australian shareholders. Specifically, Freehills notes the following features of the current regime:

- the board of directors bears unequivocal responsibility for the management of the company;
- the board of directors is able to tailor remuneration arrangements to take into account the financial, strategic and operational objectives of the company;
- the board of directors is compelled to report to shareholders on its actions, including detailed reporting obligations in respect of remuneration paid to key management personnel;
- shareholders are granted broad rights to question the board of directors (and the auditor) in relation to the remuneration of company executives; and
- shareholders are given the statutory right to take assertive action against directors where they are not performing their role by requisitioning meetings, proposing resolutions for their removal and / or circulating statements to other shareholders.

A necessary corollary of board responsibility for remuneration practices is board stewardship of remuneration structures. Accordingly, Freehills submits that any reform proposals which seek to substantially shift control of executive remuneration from the board to other parties should be strongly resisted.

Examples include calls for a binding vote on executive remuneration and the proposal announced by the Government on 18 March 2009 to substantially reduce the shareholder approval limits for termination benefits under the Corporations Act. These proposals would give shareholders greater powers to intervene in, and accordingly, a greater degree of responsibility for, the way companies remunerate their executives. This signals a move away from current corporate law principles.

In our experience, companies view seriously, and have been active in responding to, the non-advisory vote on the remuneration report. Where a significant 'no vote' has been received companies already take considerable measures to address this, including re-assessing their remuneration framework and engaging in dialogue with institutional shareholders, proxy advisors and other governance bodies (including the Australian Shareholders' Association (**ASA**), which represents the interests of retail shareholders).

Freehills considers that there is a significant risk that law reform proposals which reduce the board's control over, and responsibility for, the remuneration setting and structuring process could actually serve to erode accountability to the detriment of the company and its shareholders.

[25] The exceptions to the need for shareholder approval apply in respect of payments made in consideration for the agreement to take office, damages payments for breach of contract and payments for past services rendered, and are subject to a formulaic cap under the Corporations Act.

[26] Listing Rule 10.14.

[27] Listing Rule 10.17.

This is a view shared by major corporate governance bodies. The Australian Institute of Company Directors (**AICD**) issued its 'Executive Remuneration Guidelines for Listed Company Boards' in February 2009. These are designed to assist large publicly-listed companies negotiate and set executive remuneration. The guidelines reflect AICD's view that executive remuneration should remain a matter for boards, and that further regulation in this area is unnecessary and may be counterproductive to the desired outcomes sought.

The ASA and APRA have also emphasised the role of the board in governing the remuneration practices of the company and, as discussed in section 1.2 above, APRA has developed a principles-based framework (as opposed to binding rules) for executive remuneration which will apply to APRA regulated organisations. In this regard, Freehills notes that paragraph 3 of the Practice Guide states that the board has 'ultimate responsibility for the sound and prudent management of a regulated institution, including remuneration arrangements'.

2.3 Ensuring transparency and accountability

Remuneration disclosures are governed by extensive statutory obligations and accounting standards. Under the current system, there is the risk that transparency is being clouded by 'over disclosure'. This in turn can diminish the accountability of the board for remuneration structures.

(a) Transparency of remuneration reporting

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. For example, the numerous disclosure requirements in respect of equity grants are both time consuming and difficult for retail shareholders to understand as well as being costly for companies to comply with.

Information about remuneration arrangements should be accessible by both institutional and retail investors. To this end, the disclosures in the remuneration report should be structured on the basis of the *actual* value derived by the executives from the various components of their remuneration. For example, one way to effect simpler disclosure would be to disclose the accounting values of equity grants in the notes to the financial statements (for sophisticated investors and other users of a company's financial information), and include the 'realised' value of those grants in the remuneration report itself.

Simplifying remuneration disclosures in this way would also assist shareholder to assess whether the company's remuneration structures are appropriately aligned to performance and the degree to which companies have appropriate mixes of short, medium and long term incentives.

Finally, 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 (ie where it would not be prejudicial to the company's ongoing interests to do so).

(b) Reducing compliance costs

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 as discussed above 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'.

3 Role of institutional and retail shareholders (TOR 3)

3.1 Shareholder influence

The division of corporate power between the board and shareholders (ie the division between the directors acting as the board of the company and the shareholders acting in general meeting) is based in the Corporations Act, the Listing Rules and a company's own constitution. As set out above, pursuant to this framework, shareholders already have a significant role in the oversight of the board of directors.

The Corporations Act requires extensive disclosure of executive and director remuneration to be included in the remuneration report (as discussed in section 2.3). Shareholders can then question the board about the company's remuneration policies and practices at the annual general meeting and give feedback via the advisory vote on the remuneration report (eg by voting against its adoption). Directors remain ultimately accountable to shareholders, who can vote against the election or re-election of directors at the annual general meeting (or otherwise remove them from office) if they do not agree with the board's management of their company.

In this respect, both institutional and retail shareholders have significant power to monitor and influence the board in various ways.

Institutional investors have an important role in monitoring the boar d, particularly where they hold a sufficiently large shareholding to be able to influence directors directly. Institutional investors have also exerted influence by acting together, either informally or formally through organised groups.

In addition, retail shareholders enjoy significant powers under Chapter 2G of the Corporations Act, which broadly enables:

(a) members with at least 5% of the votes that may be cast; or

(b) at least 100 members who are entitled to vote at the meeting,

to requisition company meetings, propose resolutions and circulate statements to the other members about a resolution or matter at the general meeting. Accordingly, retail investors are granted opportunities to participate and influence the affairs of the company.

Further, even where the presence of large institutional shareholders in a company 'dwarfs' the voting power of retail shareholders, the manner in which retail shareholders vote still has a persuasive effect on the company. Experience suggests that companies, analysts and commentators routinely consider the outcome of the annual general meeting proceedings in light of the division between retail and other institutional shareholders.

The above measures ensure that the board is sufficiently accountable to all members, without an undue transfer of the high level management functions of a listed company to a large member base with differing interests.

3.2 Non-binding shareholder vote on the Remuneration Report

Currently, the vote on the remuneration report is non binding and advisory only. Any suggestion that the shareholder vote on the remuneration report should be binding is impractical for a number of reasons.

Firstly, it is not immediately clear from the 'no vote' which particular aspect of the remuneration structure (or even poor drafting of the report itself) has elicited the negative response. Further, if the 'no vote' was binding, it would be difficult to imagine how, in practice, this could alter the company's obligations. For example – which aspect of the company's remuneration must be changed? Will the company be required to implement these changes retrospectively and will executives therefore owe liabilities to their company? What about the liabilities the company potentially exposes itself to in terms of the contractual obligations it has to executives?

The advantage of a non-binding vote is that it provides an effective avenue by which boards receive shareholder feedback on director and executive remuneration and

provides a starting point for meaningful dialogue between the company, institutional shareholders and proxy advisors (who are often consulted before the release of the remuneration report to the market).

As discussed above in section 2.2, in our experience companies view the advisory vote on the remuneration report seriously and respond accordingly.

However, if the government wishes to strengthen the non-binding vote, one possibility may be to include an additional reporting requirement in the following year's remuneration report. Broadly, if the remuneration report receives a 'no vote' in one year, the following year's remuneration report could be required to include a statement as to whether the company has taken any action to address shareholder concerns, and if no action has been taken, an explanation of why not (similar to the 'if not why not' reporting under the ASX Corporate Governance Principles and Recommendation (**ASX Principles**)).

4 Mechanisms to better align the interests of boards and executives with those of shareholders and the wider community (TOR 4)

4.1 Whose interests must be considered?

The duties directors and officers owe to the company (and consequently, shareholders) are fundamental to company law. As set out above, directors and officers have numerous and stringent duties to the company under the Corporations Act, at common law and in equity.

The duties themselves (including the duty to act in the best interests of the company and for a proper purpose) guard against malfeasance in remuneration practices. Requiring boards to consider the interest of the community at large (in addition to the company and shareholders) when exercising their powers and discretions significantly undermines and weakens directors' fundamental legal duties.

4.2 Aligning interests

Corporate governance principles recommend that a significant proportion of executive pay be 'at risk' based on company performance in order to align executive interests with those of shareholders. The ASX Principles contain guidelines in this respect, noting that 'performance based remuneration linked to clearly specified performance targets can be an effective tool in promoting the interests of the companies and shareholders'.[28]

Companies are also guided by corporate governance stakeholders who support performance measures which foster a 'long term' view. For example, the general consensus amongst proxy advisory groups is that long term incentive instruments should not vest prior to 3 years after grant.

In addition, as discussed above, while APRA's Practice Guide will apply specifically to companies in the financial services sector, it is likely that it will set a more general benchmark / guidance for other companies as well.

Companies are also beginning to question traditional financial measures and are looking at different combinations of incentives to create stronger alignments with company performance, including by adopting more individualised performance measures which reflect the long term corporate strategy objectives.

If the government wishes to provide further guidance to companies on the appropriate measures needed to align remuneration with shareholder interests, it should do so through the adoption of a non-binding code, similar to the ASX Principles (including 'if not why not' style reporting). Such a non-binding code may assist companies to choose performance metrics and decide on the remuneration structures which are most appropriate for the company.

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[28] Box 8.1 of the ASX Principles

However we note that there are already numerous sources of guidance including views and guidelines published by corporate governance bodies, proxy advisors and regulators (for example, APRA). Furthermore, there is a significant risk that the introduction of a new code could exacerbate compliance costs for companies and increase the amount of information required to be included in the annual report.

4.3 Proposed removal of the tax deferral on employee share plans

The 2009 Federal Budget included an announcement that the Government intends to abolish deferral of tax on the upfront discount for employee equity schemes. This proposal, if implemented, would be a significant disincentive for companies to offer shares, options or other ‘at risk’ equity remuneration. For example, executives will be reluctant to participate in an employee equity scheme where they are required to pay tax up front, especially where the instrument may never vest and result in equity ownership.

There is a significant risk that this proposal, if implemented, will result in a loss of alignment between company performance and remuneration. Numerous successive Australian governments have recognised that employee equity schemes are an effective tool in linking the interests of the executives with those of shareholders (ie granting executives the same ‘ownership’ in the company to reduce agency costs). This promotes an alignment between the objectives of executives, the company and the shareholders alike.

Further, this proposal is at odds with the treatment of tax on employee share plans in most other OECD countries, and could potentially put Australian companies at a comparative disadvantage in trying to attract foreign talent (especially in specialised industries).

The proposed reforms may also result in an increase of non-recourse loans being made by companies to executives in order to provide a long term incentive which is tax neutral. As the Issues Paper highlights, AICD along with other corporate governance stakeholders are opposed to such arrangements, as they dilute the ‘at risk’ aspect of share ownership.

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Freehills

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