Australian Shareholders' Association
Standing up for shareholders

Submission to the Productivity Commission:

Regulation of Director and Executive Remuneration in Australia

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Introduction

The ASA welcomes this opportunity to provide the Productivity Commission (The Commission) with the views of retail shareholders on the issue of executive remuneration. Excessive executive remuneration has been a concern of the Association, its members and retail shareholders generally for many years. Whilst the financial crisis has sparked public and media interest in the multi million dollar packages paid to executives of listed companies, this is by no means a new issue.

The ASA makes a number of recommendations in this submission. In so far as those recommendations are for further regulation they call for minimal government intervention. It is firmly the view of the ASA that it is within the current powers and responsibilities of the directors of listed companies to control excessive executive remuneration.

About the ASA

The Australian Shareholders' Association (ASA) is a not-for-profit organisation formed to represent, protect and promote the interests of investors in shares, managed investments, superannuation and other financial investments.

The ASA Company Monitoring Program

Each year the ASA monitors listed company performance and governance. In 2009 the ASA will monitor 200 companies and has over 80 volunteer monitors. The monitoring process includes engagement with boards and monitors generally meet with the company's chairman prior to company meetings. The ASA accepts appointment as a proxy on behalf of members and the public and publishes intentions for the voting of open proxies on its website prior to company meetings. Those intentions are available for both members, and the public to view.

Definitions and Scope

1. **What is an appropriate definition of 'remuneration'? What aspects or elements of remuneration should be included?**

   The Australian Accounting Standards, *AASB 124, Related Party Disclosures* defines remuneration as:

   (a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

   (b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

   (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

   (d) termination benefits; and

   (e) share-based payment.[1]

   All of the above elements should be included in when defining remuneration. The issues paper also notes that non-recourse loans can form part of remuneration. The ASA does not support the use of non-recourse loans to executives, but agrees that where used these loans should be considered to form part of an executive's remuneration.

2. **What is an appropriate definition of 'executive'? Does the remuneration report required under the Corporations Act and its coverage of key management personnel provide a suitable definition? Should the Commission's coverage of executives go beyond this, and if so, why?**

   The ASA is satisfied with the definition of key management personnel provided by *AASB 124, Related Party Disclosures*:

   …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.[2]

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[1] *AASB 124, 9*
[2] Ibid

3. **How should 'corporate performance' and 'individual performance' be defined? Is it possible to define them in general terms that are applicable across most businesses? Or is transparency in performance hurdles for incentive payments the more important issue? To what extent do external performance indicators 'net out' underlying market growth factors from entrepreneurial and managerial performance?**

   There are many ways to define and measure both corporate and individual performance. The most important consideration is setting hurdles which reward only superior performance, which encourage long term horizons and discourage poor managerial behaviour.

   Measures of external performance, such as to frequently used Total Shareholder Return (TSR), are not able to differentiate or exclude external factors. Whilst the ASA approves of TSR as a measurement of performance the Association recommends it is used in tandem with at least one other measurement of performance – please see TOR1, Q7.

TOR 1: Trends in remuneration

1. *How are levels of director and executive remuneration determined? What constraints exist, and what is the market's role in determining remuneration levels? What are the major drivers of negotiated outcomes? Have they changed over time?*

   It is the view of the ASA that the structure of remuneration should be primarily driven by the strategy and business model of the company, not by negotiations with individual executives and the tax and other needs of management. In reality the process of selecting and recruiting candidates for executive positions, particularly the CEO and other C-level positions is a significant driver of both the final structure and levels of remuneration.

   Retention of executives and proper succession planning are extremely important in controlling both the quantum of executive remuneration and other costs associated with the position. Appointing an external, proven candidate from another organisation, particularly for the CEO position, may appear to be low risk strategy for the board; however it adds significant expense to the process and narrows the available candidates providing greater negotiating power to the candidates. Recruitment of a well known proven candidate to a CEO position brings with it significant risks that the candidate will not know the business, the culture and if recruited from overseas will lack local knowledge.

   In negotiations between companies and external candidates there will frequently be a intermediaries such as an executive search consultant. These consultants are remunerated by way of a percentage of the final package of the executive and accordingly are also invested in achieving the highest level of remuneration for the position.

   The ASA accepts that competition for talent will inflate remuneration, but this is not the sole, or even primary reason for the current excessive levels of executive remuneration. To an extent international competition for talent is a factor 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. However the issue of international competition has been over-inflated in the Australian context. The number of foreign CEOs of Australian listed companies is not overwhelming.

   Appropriate succession planning is both a board and CEO responsibility. A significant part of a CEOs job should be ensuring that there are appropriate candidates to fill his or her position. The ASA view is that there is not a strong enough culture of succession planning in Australian listed companies and there is little incentive for CEOs to consider the life of the company following departure. ASA policy[3] requires that a meaningful proportion of both long term and short term incentive payments be held for a period of two years post vesting to deal with issues of short term horizons. The ASA Policy, *Executive Remuneration,* can be found at Appendix A.

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[3] ASA Policy, Executive Remuneration, dated 23 March 2009
http://www.asa.asn.au/PolicyStatements/ExecutiveRemunerationPolicy.pdf

2. ***What growth in the level of director and executive remuneration has taken place over recent decades, both within Australia and internationally? What factors contributed to this growth? Has the experience differed across different industries or sectors of the economy?***

The level of growth in remuneration is difficult to calculate given the differences in the valuation of the equity components of senior executive remuneration. The ASA experience through the company monitoring program is that executive remuneration in Australia has grown significantly during the past two decades. The RiskMetrics research, commissioned by the Australian Council of Superannuation Investors (ACSI) and quoted in the issues paper, indicates that there has been substantial growth in CEO remuneration since 2001. This growth coincides with a period of strong economic growth. However during the course of the ASA company monitoring program in 2008, the overall quantum of executive remuneration continued to grow despite the fact that financial performance of companies generally slowed.

Analysis of Australia's top ten companies[4] for the period 2006 – 2008, shows that only two companies (Westpac and Woolworths) recorded higher growth in profit than executive remuneration. Four companies recorded negative growth in profit while increasing remuneration by over 10% during the period.

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 structure 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 3 years or in some cases less.

In Australia, like many other jurisdictions, there have been certain sectors which have been more inventive and have sought to provide greater incentives for performance. Investment banking firms have been consistently criticised for maintaining a culture of remuneration focused on sharing profits amongst employees, more akin to a partnership than a listed company. A number of these firms have been placed in administration during the last 12 months including Allco Finance Group and Babcock and Brown, with significant questions over the levels of risk taken by executives.

ASA company monitoring has found a trend amongst smaller mining companies to issue options to executives which are not linked to performance other than by the inherent link to share price. The ASA objections to share price as a performance hurdle are set out at TOR1, Q9. Incentive schemes such as these have driven growth in executive remuneration based

[4] The top 10 companies by weight of the S&P/ ASX 50 Index: BHP Biliton, Westpac Banking Corporation, Commonwealth Bank, Telstra, National Australia Bank, Woolworths, ANZ Bank, QBE Insurance, Westfield, CSL

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.

3. ***Is there any relationship between director and executive remuneration, and the remuneration of other company employees? How important are relativities between executives and other employees? Are there flow-on effects from executives to other employees? Do big disparities serve to motivate or de-motivate other employees?***

   These questions are better answered by employee/ employer groups, however it is the position of the ASA that there is very little relativity between the levels of remuneration of ordinary employees and executives. Whether there should be such a relationship is not a matter which is not specifically within the remit of the ASA.

4. ***Are current director and executive remuneration levels justified? Have increases over recent years been justified? How should the Commission determine what is 'justified' — what tests should be applied?***

   Neither the quantum of executive remuneration nor the rate at which it has grown in the past decade can be justified. Growth in executive remuneration can only be justified by a corresponding growth in the performance of companies. Given the variables involved it is difficult for the commission to set a bench mark across the board. It is boards which must be accountable for ensuring that remuneration structures can be justified.

5. ***What relationship exists between levels of remuneration and individual and corporate performance? To what extent are remuneration levels required to generate an adequate supply of suitable directors and executives; that is, are they primarily aimed at hiring and retaining the right person, rather than influencing their performance?***

   Current levels of executive remuneration owe more to the process of negotiation of individual contracts, than a consistent and structured approach by companies to link corporate strategy and performance with executive remuneration.

   Whilst this is a difficult issue to quantify, the experience of the ASA in discussing remuneration with boards is that requests for improvement to remuneration structures are frequently met with arguments that the current structures are required to retain individuals, or that particular terms of an individuals contract could not be negotiated. These arguments about the competitive executive labour market continue to be present even in the current tight market, with boards supporting loosening of current remuneration structures or changes with arguments that they are necessary to retain executives in difficult times.

6. ***What are the key drivers of performance for directors and executives? Are there factors other than remuneration that influence their performance?***

   There is a substantial academic literature on the issue of motivation of executives and other employees, but very little agreement on the primary drivers of the performance. Remuneration is obviously a very tangible and quantifiable form of motivation. Other factors which are less tangible but undeniably contribute to an individual's performance are job satisfaction, acknowledgement, achievement, promotion and position.

7. ***What changes have taken place in the type and structure of remuneration over recent decades? What has driven these changes? Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director and executive behaviour inconsistent with the interests of the company? Are particular types of remuneration more likely to produce these outcomes? Has the experience differed across sectors (for example, the finance sector relative to other areas of business)? Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?***

   The growth in the proportion of executive's total package linked to performance and 'at risk' has been the most significant change in remuneration. The ASA is not opposed to the concept of linking remuneration and performance and exposing executives to the same risks and rewards as shareholders. However the experience of the Association is that many of the schemes said to align executives with shareholder interests do not achieve that aim and in fact provide extremely large rewards for only average performance, are too short term and can encourage poor managerial behavior.

   The most popular ways of linking performance to pay are to use long and short term incentive schemes. Frequently the division of total remuneration is split in thirds between base pay, short term incentives and long term incentives.

   These changes have been driven by an acceptance that aligning executive pay with corporate performance both deals with the principle-agency issues that result from splitting ownership and management and also maximise returns to shareholders.

   In principle concept of incentive based remuneration is attractive to shareholders. However incentive based schemes which are not well structured or have not been adequately stress tested can have unintended consequences that can negatively impact the long term performance of the company.

   Long term schemes frequently use equity as a reward for achieving pre-determined performance hurdles. These hurdles differ from scheme to scheme; although in Australia there have developed a number of boiler plate schemes. Long term incentive plans (LITPs) rarely measure performance over periods of greater than 3 years. Measures of

performance vary, but popular measures are growth in earnings per share (EPS) and total shareholder return (TSR).

All measures of company performance used to reflect executive performance have inherent weaknesses. The ASA approach is to ask companies to link equity rewards in long term incentives to at least two different hurdles; one which is a measure of performance closely aligned with shareholder interests and a second measure which reflects a growth in earnings of the firm.

8. ***Why and/or when are the dealings between shareholders and companies on remuneration issues a matter of public interest?***

It is the ASA view that it is in the public interest that companies perform well, grow and return a profit. A company which performs well will provide returns to the communities in which it operates. In this broad sense executive remuneration as a driver of performance is an issue that should be a matter of public interest.

The investment by the Australian's in superannuation also brings remuneration within the sphere of public interest. Investors in superannuation have minimal direct ability to influence the trustees of their funds, and no direct influence over the management of the investments made by the fund.

Given that the public interest in this issue is very broad the ASA view is that knee jerk reactions to public sentiment about levels of executive remuneration should be avoided and the interests those submitting to the inquiry without a direct interest should be thoroughly understood before adopting any recommendations.

9. ***What relationship exists between the structure of remuneration and individual and corporate performance? What are the key drivers of performance for directors and executives? What arguments, for and against, are there for linking remuneration and the share price?***

Reference is made to TOR1, Q 5.

The ASA does not support the use of share price as a measure of performance. Share price in its unadulterated form is not a good measure of executive performance for the following reasons:

- The share price is effected by external market factors beyond the control of an executive. Accordingly an executive could be rewarded/ penalised for factors over which he or she has no influence

- The share price is open to manipulation and linking rewards to a particular price, growth rate etc could encourage market manipulation[5].

Total shareholder return (TSR) a measure which takes into account both changes in share price and earnings, is a better measure but like all measures still has weaknesses. These weaknesses however can be controlled by adopting more than one measure of performance.

[5] ASIC are currently prosecuting the former managing director of Select Vaccines, a listed company, for breaches of the Corporations Act 2001, alleging that he caused the sale of shares in the company in order to increase the share price to the required level of a hurdle in his service contract. *ASIC Media Release, AD09-03 ASIC commences proceedings against former Melbourne chief executive officer & managing director.*

TOR 2: Effectiveness of regulatory arrangements

1. ***Given that it is ultimately the responsibility of the board to engage a managing director and other key executives, including associated terms and conditions, what changes would assist the board in fulfilling this role, consistent with shareholder interests?***

   It is unlikely that there is a simple regulatory response to the problem of excessive remuneration. Primarily the ASA sees this as an issue of a lack of board accountability to shareholders.

   It is difficult to envisage how changes could be made to the current regulatory regime to assist boards without becoming prescriptive as to the types of arrangements that companies could make with executives. It is the ASA view that boards should not be fettered in this way, but should be held accountable for the decisions made in this process. In particular payments which are not base pay or linked to performance such as:

   - signing bonuses
   - compensation for earnings/ benefits lost at a previous employer
   - termination payments

   should be avoided. If these payments are made, the board should be in a position to explain why they were made and how they benefit the company.

2. ***How effective are arrangements for director and executive remuneration under the Corporations Act and ASX listing rules and guidelines? Do arrangements provide sufficient transparency and accountability on remuneration arrangements and practices? How might transparency be increased, and what might be the impacts of this?***

   The introduction of the remuneration report has provided shareholders with a much greater level of information and transparency. Even in the cases where the report is complex and unwieldy it is an improvement on the previous levels of disclosure. The Corporations Act requirements in relation to the remuneration report are sufficient. Improvements in the usefulness of the information must be driven by a shift by companies from focus on compliance to a focus on communicating with shareholders.

   The ASX Corporate Governance Council Principles and Recommendations (the Principles) provide investors and companies with high level guidelines. The Principles require that companies comply or explain. It is the view of the Association that the most significant role of the Principles is to focus companies on issues of corporate governance. *Principle 8: Remuneration Fairly and Responsibly,* requires companies to comply or explain in relation to three recommendations. Principle 8 continues to have impact in changing the culture within companies to one which identifies remuneration as significant issue – please also see Q 6.

3. ***Are the current disclosure requirements in the remuneration report too complex? Is the coverage of executives in the remuneration report appropriate? Would shareholders benefit from access to readily accessible, consolidated information, on director and executive remuneration?***

   The current requirements are not too complex, however the reports which result are frequently unnecessarily complex. With some exceptions remuneration reports are written to comply strictly with the letter of the law, not as they should be, to provide information for shareholders and other stakeholders. The problem is not the requirements but a lack of communication and in some instances what would appear to be a deliberate attempt to obscure information.

   Shareholders are increasingly choosing not to receive the hard copy annual report. Retail shareholders are more likely to read the abbreviated shareholder review documents that many companies continue to send in hard copy. The ASA in its policy, Annual Review Document[6], suggests that this document should include consolidated information on remuneration with the relevant references to the Annual Report. The *Annual Review Document* policy in annexed to this document – see Annexure A. Although the ASA does not seek to mandate consolidated information on remuneration, companies should be encouraged to provide this as part best practice communication with shareholders.

4. ***Is there an appropriate balance between legislated requirements and voluntary guidelines? What is the role of voluntary guidelines in governance of director and executive remuneration?***

   Given the need for flexibility, the ASA believes there is currently an appropriate balance between legislation and voluntary guidelines. The ASA's view of the role of the Principles is explained above. Guidelines, policies and standards provided by industry bodies allow for a greater level of detail both in terms of required disclosure and prescribing how remuneration is best structured to achieve appropriate outcomes.

   Compliance by companies with industry guidelines largely depends on the level of influence the body is seen to have. The ASA, although relatively small, has been successful in engaging with companies and effecting change. The ASA not only uses its own policies in engaging with companies, but frequently lets companies know where they are out of step with other guidance. Voluntary guidelines have the most influence where shareholders, both large and small vote consistently across all companies they are invested in, in accordance with the guidelines. A higher level of participation by institutional investors, as well as disclosure of their voting record to members may assist in elevating the role and importance of voluntary guidelines.

[6] ASA Policy, Annual Review Document, dated 26 October 2007
http://www.asa.asn.au/PolicyStatements/AnnualReviewDocumentPolicy.pdf

5. ***Is the case for regulation stronger where government is an active participant in company activities, for example through the use of taxpayer funds to bailout companies in financial difficulty or through other ongoing support activities?***

   A situation such as the bank bailout in the United States could provide an argument for Government intervention in remuneration, particularly where poor management is the cause. This situation has not occurred in Australia to date. It is the view of the ASA that any intervention would need to be considered by the Government taking into account the particular circumstances relevant to the individual companies involved.

6. ***Are there any voluntary, good practice guidelines or codes applying internationally that may be of interest in an Australian context? Should Australia consider the adoption of a code of practice?***

   There are a number of industry policies, guidelines and codes in Australia with regard to remuneration. Whilst these various documents share some similarities, it is inevitable that stakeholders will have different priorities and views. In principle a code of practice is attractive to shareholders. However given the broad range of circumstances and stakeholders it would need to cover it is likely that such a code would be very high level.

   In excess of 100 submissions were made during the consultation process for the second edition of the ASX Corporate Governance Council Principles and Recommendations (the Principles). The ASX Corporate Governance Council (the Council) includes representatives from 21 industry bodies. The second edition of the Principles includes three recommendations with regard to remuneration – Principle 8.

   A code is unlikely to achieve a greater level of detail in either disclosure requirements or best practice guidelines than is currently provided in the Principles. A proliferation of guidelines would not be helpful. As compliance with any code would be voluntary, it would be unlikely to address the persistent problem of actual compliance – rather than compliance with the letter of the code.

   Rather than adopt a code of practice the ASA would encourage the Commission to consider whether there are recommendations that could be considered by the Council for addition to the Principles.

7. ***To what extent have remuneration committees been used in Australia? What effect have these had on the linkages between remuneration levels and individual and corporate performance?***

   The extent to which the establishment of a remuneration committee has had any effect on the linkages of remuneration levels and individual and corporate performance is very difficult to assess. The existence of a committee certainly indicates that there is a considered focus on the issue by the board. It is not an indicator that the company's remuneration policies and structure necessarily deliver the best results for shareholders.

8. *Do conflicts of interest arise in the arrangements by which remuneration consultants advise on director and executive remuneration? If so, how significant are they and how might they be addressed?*

   The current legislation does not require any reporting in relation to remuneration consultants. It is possible to foresee a situation where a consultant is engaged to undertake various pieces of work within a company and to advise both management and the board. In those circumstances there may be a conflict.

   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. The issues paper notes the Australian Institute of Company Directors (AICD) guidance on this issue, with which the ASA concurs.

TOR 3: The role of institutional and retail shareholders

1. ***What degree of influence should shareholders have in their own right in determining remuneration practices? Do current regulatory arrangements enable shareholders to be adequately involved? If not, why?***

   Currently shareholder influence on remuneration practices stems mainly from the advisory vote on the remuneration report. This is one end of the influence spectrum. At the other end is the concept of a binding vote on remuneration. Unfortunately there appears to be little middle ground between these two options.

   The ASA 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. In those circumstances an against vote would be unlikely to provide useful guidance as to what is acceptable.

2. ***Does the current non-binding vote require strengthening? Is it appropriate for directors and executives that are named in the remuneration report, and who hold shares in the company, to be able to participate in the non-binding vote?***

   The non-binding vote would be strengthened by putting in place mechanisms to make directors accountable for acting on the concerns of shareholders. Please see the final section of this submission – Recommendations.

3. ***To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers? Are there areas where their rights should be strengthened? Does institutional voting typically align with the broader interests of shareholders?***

   Institutional shareholders have become much more active shareholders in recent years, both in terms of engagement and voting. Voluntary industry guidelines including the Investment and Financial Services Association Blue Book have greatly assisted in this process.[7]

   However many institutional investors still do not take an active role. The ASA would encourage the Commission to investigate whether it is possible to do more to achieve both active participation in corporate governance by those shareholders and reporting to fund members.

[7] The Blue Book that states that fund managers should vote and should provide a summary of voting annually

As there is no compulsion to report institutional voting, it is difficult to say with any certainty if it generally aligns with the broader interests of shareholders.

4. ***In what aspects of remuneration practices and setting remuneration levels would it be appropriate to increase shareholder involvement? How would this be best achieved — without, for example, diluting the intended function of the board in engaging the managing director/chief executive officer?***

It is a matter for boards to set the remuneration of executives, having reference to the company's strategies and business model. It is the place of shareholders to hold boards to account.

The ASA does not support a binding vote on remuneration for the reasons set out in the response to question 1. There are areas where elements of executive remuneration could be made the subject of shareholder approval. One such area, termination payments, is currently being addressed by the Government.

The ASA 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. The difference is the dilution of existing shareholders caused by new issues. 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.

The ASA would like to see this requirement extended to all incentive plans granting equity to executives. Such a requirement would place a much greater onus on the board to ensure that incentive schemes actually reward superior performance and are genuinely long term. Although these changes could lead to an increase in cash payments instead of equity, shareholders would be able to object to attempts to circumvent their approval by voting against the remuneration report.

TOR 4: Aligning interests

1. ***To what extent do current taxation arrangements influence the level and structure of executive remuneration? To what extent should bonuses be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?***

   The current taxation arrangements play a significant part in the levels of equity remuneration. The recent changes to the tax treatment of equity rewards announced in the Budget have left considerable uncertainty over the future of equity based remuneration. The changes mean that equity will be taxed in the year it is granted.

   The ASA supports a system which allows equitable outcomes on taxation. However the unintended consequences of changes, such granting higher bases salaries to executives to offset increases in taxation, are likely to maintain inequity.

   If it is accepted that equity incentive schemes, properly structured, benefit company performance, the tax system should not penalise companies using these schemes.

   Both the current timing of tax on equity and the proposed changes create difficulties for companies seeking to hold vested equity for a period after the departure of executives, as recommended by the ASA. This is both part of ASA policy (see TOR1, Q1) and a practice that the AICD in its Executive Remuneration Guidelines recommends companies should consider. The intention of the ASA policy is to ensure executives continue to hold equity in the company for a period of at least two years after departure. The current laws require that tax would be assessed on any equity at termination. This is an area which requires careful review.

2. ***What evidence or examples indicate that the interests of boards and executives may not be adequately aligned with those of shareholders and the wider community? What factors have contributed to any misalignment?***

   Evidence of misalignment of the interest of boards and shareholders is most evident in the advisory vote on the remuneration report. During 2008 the following companies received majority against votes on the resolution seeking approval of the remuneration report:

   Valad Property Group, 76%
   Boral, 58%
   Transurban, 58.56%
   Wesfarmers, 50.42%

   The companies below received high but not majority against votes:
   Toll, 42.94%
   Asciano, 32.85%
   Suncorp-Metway, 32%

The ASA voted open proxies against the remuneration report at 76 (55%) of the 137 AGMs attended in the calendar year 2008.

3. *What are the interests of the wider community in relation to director and executive remuneration within a company? To what extent do the interests of shareholders and the wider community align? In what circumstances will they not be aligned? Can cost cutting by companies, including by sacking workers, align with the public interest? Is it reasonable to reward executives for actions that promote shareholder interests but which may not align with the public interest?*

Although in the short term there may be some instances of a divergence of shareholder and public interest, in the long term these will generally be aligned. Financially healthy, growing and sustainable companies in the long term will contribute to the community.

4. *What types of performance measures/hurdles could be used to accurately measure performance and align interests of executives and shareholders?*

ASA policy requires companies to divide any equity rewards and assess performance on two different measures. One half of the rewards should be clearly aligned with shareholder value, and accordingly companies should use a hurdle such as relative TSR which reflects both capital and earnings growth for investors. The other half of the rewards should be linked to a measure of long term improvement in company performance. This should typically be a measure which reflects a superior level of company earnings, such as earnings per share or return on funds employed.

No measure of performance is without fault. The hurdles should be chosen to complement each other and to act as a control for one another. For instance relative TSR is often criticised for delivering gains to executives where the company performs well against a peer group which has performed poorly. Use of a second hurdle based on a measure which is not comparative, but absolute such as earnings per share, prevents an executive from earning all of the possible rewards where year on year company performance is not above average. Similarly absolute hurdles which compare only year on year performance of the individual company do not allow investors to compare the performance of executives against peers.

5. *How can opportunities for executives to 'game' incentives be minimised?*

Most measures of performance have potential for manipulation. This can take the form of making legitimate choices about accounting treatment and other decisions that are open to a level of subjective decision by executives. In more extreme cases it can take the form of marginal or illegal activities such as market manipulation.

There are a number of opportunities to minimise the potential for manipulation. Primarily companies need to focus on ensuring that executives' horizons are suitably long term. The average retail investor has a horizon of between 7 – 10 years, while the average term of a CEO is slightly less than 5 years.

ASA policy requires companies to take the following steps to minimise short term focus and gains:

- Be sparing in the use of short term incentives (STI), 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
- Ensure that LTI schemes are suitably long term. ASA policy requires that performance under these schemes be assessed over not less than 4 years
- Delay receipt by the executive of a meaningful proportion of any STI or LTI earned (to be held in equity) for a period of at least two years after vesting.

The use of more than on measurement of performance also acts to prevent manipulation. Avoiding share price as a hurdle will act as a deterrent to market manipulation.

6. ***Are boards properly exercising their functions on behalf of shareholders? Are they being unduly influenced by chief executive officers? If so, why?***

It is the view of the ASA that there is currently an imbalance in favour of executives when setting remuneration. The causes include the following:

- Either a real or perceived tight executive employment market in the last 5 – 10 years
- A lack of choice for executive positions caused by an inability to promote internal candidates
- A level of empathy between boards and executives
- The concentration and lack of diversity of non-executive directors.

7. ***Are some forms of remuneration more likely than others to promote a misalignment between the interests of boards and executives and those of shareholders and the wider community?***

Please see Q4 and Q5 above.

8. ***Are taxation considerations, either from the company's or executive's perspective, driving the design of remuneration packages? If so, what changes are required? How should bonuses be treated for taxation purposes — should they be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?***

Please see Q1above.

9. ***Is it appropriate that there be separate treatment of financial institutions? If so, why and in what way? Are there any risks from such an approach? Are there other sectors that would require a differentiated approach?***

   Subsequent to the release of the issues paper this matter has been addressed by the Australian Prudential Regulation Authority. The ASA does not see a case for different treatment of other sectors.

10. ***If current mechanisms are not serving to align the interests of the board and executives to those of shareholders and the wider community, how could regulatory arrangements and remuneration practices better secure this? For example:***

- ***should shareholder votes on remuneration reports be (more) binding?***

  The ASA does not support a binding vote on the remuneration report – please see TOR 3, Q 1.

- ***are the current approval processes for equity-based remuneration appropriate?***

  The Commission should consider whether all equity based remuneration schemes should be subject to prior shareholder approval. Please see TOR 3, Q4.

- ***what effect does hedging have on aligning interests, and should this practice be permitted?***

  The ability to hedge, or enter into other arrangements to reduce the risk of equity based payments, negates the purpose of using equity as a form of remuneration. Executives should face the same risks as shareholders.

- ***is the current regulation of non-recourse loans appropriate?***

  Non-recourse loans, like hedging arrangements, reduce the risk inherent in equity rewards. Few companies continue to provide these loans. It may be appropriate to regulate to prevent such loans being made, however boards can simply grant performance rights or shares at no cost to the executive instead.

- ***what is the role of remuneration consultants and what has been their influence on remuneration practices, including levels, growth and structures of remuneration? Do any conflicts of interest exist?***

  The role of remuneration consultants should simply be to provide advice to the board on appropriate ways of achieving appropriate outcomes on remuneration. In practice the ASA has found that many Chairmen, company secretaries and others who should have a good understanding of the remuneration structure and the reasons for it, frequently defer to the consultants.

  There is certainly a potential for conflict to exist, particularly where the same consultants provide advice to the board as well as management.

- ***should government have a greater role in regulating remuneration?***

  Please see Q 11 below and Recommendations.

11. ***What are the costs and benefits of any options/mechanisms to more closely align the interest of boards and executives with those of shareholders and the wider community? What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?***

    The ASA has recommended some further regulation of executive remuneration to strengthen the current regime and in particular to make boards more accountable to shareholders.

    Ultimately the board should have responsibility for setting executive remuneration as an essential part of its responsibility to shareholders. Limiting that responsibility or negating it by imposing restrictions would potentially have long reaching consequences for the competitiveness of Australian business.

    In particular the ASA does not recommend the following:

    A. Capping executive salaries
    B. Tying executive salaries to multiples of average weekly ordinary times earnings or the remuneration of public officers such as Members of Parliament, senior public servants etc
    C. Changing the current advisory vote on the remuneration report to a binding vote.

TOR 5: International developments

1. *Are there any international approaches particularly applicable to Australia?*
2. *Are there particular lessons for Australia from international approaches and experience — both successes and failures?*

The ASA does not seek to recommend any particular international approach.

ASA Recommendations

A. The Commission should investigate and consider ways to ensure a greater level of director accountability for remuneration. In particular the ASA recommends the following to strengthen the resolution on the remuneration report:
    1. Require the resolution approving the remuneration report to reach the higher special resolution threshold of 75% before it can be said to be passed
    2. Require the chair of the remuneration committee at the time of a majority against vote to automatically face election at the next annual general meeting of the company

B. All equity based remuneration schemes should be approved by shareholders

C. The Commission should consider requiring institutional investors to both vote any shares held and to report to members on how shares are voted

D. Review of the timing of the taxation of equity components of remuneration.

Appendix A: ASA Policy, Executive Remuneration

Executive Remuneration

ASA Policy Statement: 23 March 2009

Background

Rates of increase in executive remuneration have accelerated over the past decade to such an extent that multi-million dollar packages have become commonplace in larger listed companies. The gaps between the pay of Australian CEOs and senior executives on the one hand, and other employees and the workforce in general on the other, have become huge and are the subject of increasing levels of valid criticism.

Retail shareholders have long been sceptical of the need for Australian CEOs to be remunerated with such increasing largesse. They have questioned the necessity, often claimed by boards, of having to meet international standards set by the two highest paying regimes of USA and UK. They view with suspicion the advice of "independent" remuneration consultants contracted by, and accountable to, those same boards. Retail shareholders have widely condemned the large termination payments granted to CEOs and others who have left their positions on retirement, resignation or sometimes following unsatisfactory performance. There is also increasing concern about high levels of short-term incentive payments and the potential for executives to focus on achieving short-term goals to the detriment of the longer-term interests of shareholders.

The structures of those components of remuneration packages which are classified as long-term and short-term incentive payments, often described as "at risk", have been challenged with some success and it is now the norm for payments to require preset performance hurdles to be met. Nevertheless, progress here has been modest and there remains a widespread view that incentive payments are too easily given for performance which is satisfactory only and by no means superior, and that these payments are neither earned nor well aligned with returns generated for shareholders.

Recent and current global financial turmoil and the accompanying massive diminution in shareholder wealth have reinforced the view that senior executive remuneration levels are excessive. Equally disturbing, in too many cases they have provided support to shareholders' conclusions that incentives embedded within remuneration structures are not well aligned with the interests of shareholders and encourage activities that conflict with long term wealth creation. The Australian Shareholders' Association (ASA) does not support statutory restrictions on remuneration levels and believes it is the responsibility of the boards of companies to deal with the problem. Nevertheless, ASA recognises an increasing risk of intervention by the Australian Government if the corporate sector fails to act. Consequently, ASA has prepared this updated policy paper for the guidance of listed companies. This updated policy position represents a hardening of ASA's position to one that is more reflective of the attitudes of retail shareholders towards remuneration issues.

The ASA Position

1. The structure and disclosure of executive remuneration should be concise, easily understood and transparent to investors.

2. The base salaries of senior executives need to be and in the great majority of listed companies probably already are, at sufficient levels to provide full and appropriate compensation where performance is adequate but not superior.

3. Incentive payments in addition to base salaries are acceptable where these reward superior, as against merely satisfactory, performance, which has been proven by the achievement of predetermined and challenging targets.

4. It is appropriate for the remuneration package of a CEO to include a substantial "at risk" element. As a broad indication only, intended as a guideline for any board which is planning the structures of its CEO's remuneration package, an incentive award equal to the amount of the base salary package is acceptable for a CEO who has achieved significantly superior performance. Payments which are significantly above this level, other than on an exceptional basis, are excessive and are unacceptable to retail shareholders.

5. Long-term incentive (LTI) arrangements based on preset performance hurdles and properly aligned with the interests of shareholders are the appropriate means for providing CEOs, and possibly other senior executives, with motivation and reward for demonstrated superior levels of performance. Recommended guidelines for achieving this alignment are set out below.

6. Short term incentives (STIs) are questionable as incentives for CEOs. They should be used only where the performance targets support and are entirely consistent with the company's long-term goals. STI arrangements may be appropriate for other senior executives, providing these awards are conditional upon achieving pre-set performance targets that are clearly disclosed to shareholders.

7. Boards must not permit executives to enter into arrangements (such as hedging) which reduce the risk elements essential to effective incentive schemes.

8. Termination payments to failed executives which are above statutory entitlements or that include additional amounts in lieu of notice are unacceptable to retail shareholders. Boards should consider this when negotiating departure conditions in employment contracts or subsequently.

9. Golden parachutes are totally unacceptable to shareholders. Other lump sum payments additional to the agreed annual remuneration package, for example, executive retention payments, and compensation for "benefits foregone at previous employers" are also in principle unacceptable to shareholders. Any exceptions need to be very clearly described and strongly justified as being in the company's best interests in the remuneration report.

10. Where there has been a significant, for example 20%, 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.

Guidelines

Long-term Incentives

1. ASA views long term incentives as a means of (i) rewarding executives for creating shareholder value and (ii) providing incentives to create further value. There is no single test that adequately meets the requirements of both objectives. Consequently, LTIs should be based on two components, each subject to achieving company performance above a hurdle threshold, with all details clearly set out for shareholders at the time of adoption:
    a. One component should be clearly aligned with shareholders' interests and based on the achievement of total shareholder return (TSR) above the median for an appropriate comparator group. In this case vesting should commence at a modest level (no more than 10%) only when the company achieves a 51st percentile ranking and should increase progressively to reach full vesting no earlier than at the 75th percentile of the group.
    b. The second component should provide an incentive to achieve long-term improvement in company performance, typically the achievement of a hurdle that is based on a pre-set and superior level of increase in company earnings. This can be measured by, for example, growth in earnings per share, return on funds employed or another verifiable metric that the board considers best reflects long-term progress across the cycle.

2. LTI awards should be made in equity.

3. LTI performance should be assessed over a fixed period of no less than four consecutive years, with vesting at completion of the full assessment period.

4. The share prices used within the calculation of the TSR, i.e. those at the start and end dates of the vesting period, may be subject to short-term smoothing in order to avoid the unintended effects of price volatility, (for example, averaging over the three month period around the start and ending dates of the vesting period). However in such cases the formula used must be specified within the LTI scheme at the outset.

5. Should TSR be negative over the vesting assessment period there should be no award for that component, irrespective of relative performance against the comparator group.

6. There should be no retesting of performance against LTI hurdles. The need for retesting is eliminated if the vesting period is adequate and short-term smoothing is adopted.

7. In order to promote and support management succession and other strategic long-term objectives, CEOs' equity-based plans should provide that a meaningful portion of any equity awards shall not be made available to the CEO for at least two years after vesting. This restriction should apply irrespective of whether the CEO remains in the position.

8. There should be no company loans associated with LTIs as this decouples any alignment with shareholders' interests that might otherwise have existed and is an inappropriate use of shareholders' funds.

Short-Term Incentives

1. Around 50% of STI awards should be based on verifiable financial performance metrics at the company level and/or of the area of responsibility of the individual executive.

2. The remainder of any award should be based on quantifiable performance indicators that are set at the start of the period.

3. In the interests of transparency, the performance indicators used to determine STI awards should be disclosed to shareholders. Disclosure may be retrospective if necessary to avoid disclosing commercially sensitive information.

4. Disclosure of STI amounts paid to senior executives should be supported by details of the maximum and minimum amounts available to be earned under the scheme.

5. A proportion of STI awards (ASA recommends at least 50%) should be in the form of equity. This equity must not be made available to the executive for at least two years after the end of the relevant performance period, irrespective of whether the executive remains in the position.

Appendix B: ASA Policy, *Annual Review Document*

Annual Review Document

ASA Position Paper: Friday, 26 October 2007

Background

Based on increasing anecdotal evidence, Concise Annual Reports are regarded as unsatisfactory both by companies and by shareholders. On the one hand, largely due to statutory requirements, the Concise Annual report tends to be nearly as voluminous as the full version. This discourages its study by many retail shareholders. On the other hand the Concise Annual Report omits many details (mainly in the Notes to the Accounts) which are essential for any serious analysis.

ASA believes that a briefer document, designed to meet the information needs of retail shareholders would prove to be an acceptable alternative to the concise Annual Report. Guidelines for the contents of such a brief Annual Review document are attached to this statement as Schedule 1.

The ASA Position

ASA supports the provision to shareholders of an Annual Review document as an alternative to the Concise Annual Report format which is presently offered.

PROPOSAL FOR ANNUAL REVIEW DOCUMENT

Schedule 1

The Annual Review Document is presented as a brief summary of a listed company's operation and it is proposed that it becomes an alternative to the Concise Annual Report. Some flexibility in the choice of contents is envisaged providing the chosen structure is consistently applied. Total size should not exceed four pages (A4 or equivalent). It is recognised that a review of this size cannot be a complete report, but it is essential that it is not misleading. Value judgements should be avoided in favour of facts and quantified information.

The proposal set out below lists those items, which should be included CONSISTENTLY by listed entities, which are required to produce an annual report. Consistency is to apply between companies and in the case of RESULTS IN BRIEF, between years reported. Items listed for inclusion are regarded as the minimum required. Nothing in this proposal is designed to prevent listed entities reporting additional events or values, which they feel are relevant to shareholders, such as the reporting of Key Performance Indicators by mining companies, banks insurance companies and companies involved in other industries where reporting standards and conventions differ from the norm.

THE STRUCTURE OF THE ANNUAL REVIEW:

- A brief description of what the commercial entity does.
- Abbreviated Chairman's report. (Including a report on strategy).
- Abbreviated Managing Director's report. (Including main causal factors responsible for changes in performance ratios.
- Results in brief: (see below).
- Capital management, highlights only.
- Remuneration Report: Pertinent structure only with page references to Annual Report.
- Auditors: Name of firm, a comment on independence, rotation and % breakdown of fees between auditing and non-auditing fees.
- Statement confirming: Though not specifically audited, the Annual Company Review contains figures based on the audited annual report.

RESULTS IN BRIEF: Ideally for a **five year period**, but for a minimum of two years. Separate divisional reporting of key items, when appropriate, is desirable.

The following should be shown (not necessarily in this order):

- Company TSR vs. the ASX 200 Accumulation Index.
- Operating revenue
- Net profit before tax
- Tax
- Net profit after tax, attributable to shareholders
- Earnings per share (diluted)
- Dividend per share cents
- Franking percentage
- Current Assets
- Non-Current Assets
- Total Assets
- Current Liabilities
- Non-Current Liabilities

- Total Shareholder Equity
- Intangible Assets
- Net Tangible Shareholder Equity
- Number of shares on issue (at end of year).
- Net operating cash flow, also financing and investing cash flows,
- EBIT
- EBITDA
- Contingent liabilities (if not included in Liabilities, descriptive comments only with reference to page number of full report).
- Return on equity (based on weighted average equity during year)
- Gearing (defining method used)
- Interest cover
- Gross margin (when applicable, i.e. cost of sales available)
- EBIT margin
- Return on assets (defining method used)
- Return on capital employed (defining method used)
- Dividend payout ratio