CHARTERED SECRETARIES
AUSTRALIA
Leaders in governance

29 May 2009

Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne VIC 8003

By email: exec_remuneration@pc.gov.au

To the Executive Remuneration Inquiry

Regulation of director and executive remuneration in Australia

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the Productivity Commission's (the Commission) issues paper *Regulation of director and executive remuneration in Australia*.

CSA is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. Our members comprise company secretaries in listed, unlisted, private and government-owned corporations.

In preparing this submission, CSA has drawn on the expertise of the members of our two national policy committees.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

CHARTERED SECRETARIES AUSTRALIA LIMITED ABN 49 008 615 950
LEVEL 10, 5 HUNTER STREET, SYDNEY NSW 2000, GPO BOX 1594, SYDNEY NSW 2001 **TEL** +61 2 9223 5744 **FAX** +61 2 9232 7174 **EMAIL** info@CSAust.com
www.CSAust.com

CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

Chartered Secretaries Australia (CSA)

Submission to the Productivity Commission issues paper: *Regulating director and executive remuneration in Australia*

CHARTERED SECRETARIES AUSTRALIA LIMITED ABN 49 008 615 950

LEVEL 10, 5 HUNTER STREET, SYDNEY NSW 2000, GPO BOX 1594, SYDNEY NSW 2001 **TEL** +61 2 9223 5744 **FAX** +61 2 9232 7174 **EMAIL** info@CSAust.com

www.CSAust.com

Knowledge of issues from the independent perspective of the company secretary

In public listed companies, responsibility for supporting engagement with shareholders on remuneration issues, monitoring changes in governance policies and issues of concern to shareholders in relation to remuneration and preparing the remuneration report for issue to shareholders frequently sits with the company secretary. The company secretary does not, however, make decisions concerning the levels or structure of executive remuneration: this rests with the board.

The company secretary drives and advises on best practice in governance; champions the compliance framework to safeguard the integrity of the organisation; promotes and is the sounding board on standards of ethical and corporate behaviour; and bridges the interests of the board or governing body, management and stakeholders.

Independent research has noted that:

> In order for the Remuneration Committee and Chairman to play an independent leadership role our research found that the role of the Company Secretariat was central to the successful outcome of the process, particularly where a major change in policy was taking place. Leading practice is for the Company Secretary to coordinate any necessary support to the Remuneration Committee and its Chairman. This resource is independent of the management HR systems (for example a senior independent adviser to the Committee), and can be supported by relevant expert third parties.[1]

Our members are uniquely positioned to provide independent, expert commentary on the governance issues attached to director and executive remuneration in Australia.

General comments

CSA recognises that the referral to the Productivity Commission on the issue of the regulation of director and executive remuneration has been triggered by community and political concern with the levels and structure of executive remuneration. The community, and its political representatives, are keen to examine to what extent remuneration is a private matter to be agreed between executives and companies, applying whatever governance processes properly protect the interests of owners, and to what extent there should be a community or public right to intervene in remuneration arrangements.

CSA's view is that there is considerable regulation already in place in relation to director and executive remuneration. CSA is also of the view that the current regulatory system concerning arrangements between two private parties does work, notwithstanding that there have been some recent aberrations that have caused significant community concern. However, we believe that those aberrations can be dealt with by existing governance arrangements.

The existing governance arrangements, which we detail in this submission, ensure director accountability when setting executive remuneration as well as providing for shareholder approval of non-executive director remuneration.

CSA notes that corporations legislation, in Australia and other common law countries, is very clear as to the division of responsibilities in companies. The business of a company is to be managed by or under the direction of a board of directors appointed by and accountable to the

[1] Institutional Design, *Leading Practice in UK and Australian Remuneration Setting Process*, October 2008

shareholders, and the directors exercise all powers of a company except those that are required to be exercised in a general meeting (s 198A of the *Corporations Act 2001* (Cth)) (the Corporations Act).

At no point has corporations legislation either here or overseas contemplated shareholder participation in the management of listed and broadly held companies on a day-to-day basis. That is, corporations legislation recognises that it would be impractical for shareholders to be involved in every decision. Indeed, it would paralyse a company if each decision had to go before shareholders.

Equally, corporations legislation recognises that mechanisms are required for the review of decisions taken by directors. As part-owners, shareholders should be engaged in the corporate governance of companies. They should engage with companies on long-term strategic and governance issues to provide a real test to the thinking and behaviour of boards and management, and to ensure that boards properly oversee management.

Corporations legislation recognises the role that directors play as agents for shareholders, with their fiduciary duties to act in the best interests of the company as a whole encompassed by statute and common law. Directors have responsibility to take decisions concerning the company on a wide range of matters, and decisions on those issues are not taken in isolation. Remuneration is only one element in that range of decision making. Involving shareholders in remuneration decisions would be to isolate one element of decision making from its broader context.

On the issue of remuneration, CSA strongly believes that directors should have the responsibility to determine executive remuneration, as boards are best placed to take into account the financial and operational circumstances of the company, which may shift year to year, when assessing remuneration structures. That is, CSA is of the view that boards should retain the discretion to determine the quantum, short-term incentives, long-term incentives, performance hurdles and other parameters used in determining remuneration structures. Equally, CSA believes boards should have accountability to shareholders for those decisions.

CSA does not believe that shareholders should determine executive remuneration. However, CSA does believe that shareholders should continue to have the capacity to hold directors accountable for their decisions on remuneration, as well as other decisions affecting the performance of a company. Australia has a set of robust shareholder rights. CSA points to the existing shareholder right to remove directors should board decision making be found to be unsatisfactory. The ASX Listing Rules require directors to submit themselves to re-election every three years, which also ensures that directors are subject to shareholder scrutiny on a regular basis.

CSA notes that the shareholder right to remove directors is enshrined in Australian corporations legislation, but does not exist in US corporate law, where board decision making concerning executive remuneration has been most heavily criticised. CSA also points to the fact that in the United States, in most instances, the roles of chairman and chief executive officer are held by the same person. This can result in a fundamental conflict of interest, with the executive potentially having an inappropriate degree of influence on the setting of his or her remuneration. CSA notes that this is rarely the case in Australia, where the principle of independence is central to the governance framework.[2]

---

[2] See Recommendation 2.3, ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, 2nd edition: 'The roles of chair and chief executive officer should not be exercised by the same individual'.

CSA notes that it would be misleading to make any determinations as to regulation of director and executive remuneration in Australia based on experiences in the United States, as the differences in the governance frameworks of the two jurisdictions ensure very different outcomes, in remuneration as in other governance practices.

The issues paper also refers to the broader community and its interests in relation to executive remuneration. It implicitly raises questions of the social responsibility of corporations in relation to remuneration decisions. CSA notes that the financial interest in a company rests with the shareholders, creditors and employees. The community does not have a financial stake in an executive's remuneration except if community members are shareholders. When the Corporations and Markets Advisory Committee (CAMAC) and the Parliamentary Joint Committee on Corporations and Financial Services (PJC) reported on corporate social responsibility in 2006[3], stakeholder *expectations* (which included the community broadly) were seen as separate from shareholder *interests*. This is also reflected in the ASX Corporate Governance Council's guidelines.[4] CSA is in accord with this view.

These two reports, issued after substantial public consultation, specifically addressed the issue of the social responsibility of corporations. Both reports recommended against regulating in this space. CSA notes that the issues paper specifically states that the Productivity Commission's task is to 'assess executive remuneration in terms of its effects on the productivity and performance of Australia's economy and community wellbeing'. CSA commends both the CAMAC and PJC reports on the social responsibility of companies to the Productivity Commission, as these reports deal with the responsibilities of corporations to the community.

Our comments on the issues paper are offered within the context of seeking a framework that balances shareholder scrutiny and engagement with a structure for efficient management and decision-making in a company.

Section 1: Trends in remuneration

Definitions of remuneration and executive

Remuneration

The Corporations Act already defines remuneration. Section 9 of the Act notes that any benefit given to an officer or employee of a corporation is

> remuneration if and only if the benefit, were it received by a director of the corporation, would be remuneration of the director for the purposes of an accounting standard that deals with disclosure in companies' financial reports of information about directors' remuneration.

The relevant accounting standard is AASB 124 *Related party* disclosure, which states that:

---

[3] Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations: Report*, December 2006; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate responsibility: Managing risk and creating value*, 21 June 2006

[4] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, Principle 3 which states: 'To make ethical and responsible decisions, companies should not only comply with their legal obligations, but should also consider the reasonable expectations of their stakeholders including: shareholders, employees, customers, suppliers, creditors, consumers and the broader community in which they operate. It is a matter for the board to consider and assess what is appropriate in each company's circumstances'.

Compensation includes all employee benefits (as defined in AASB 119 *Employee Benefits*) including employee benefits to which AASB 2 *Share-based Payment* applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

(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.

Remuneration is compensation as defined in this Standard.

Although the defined term 'compensation' is used in this Standard rather than the term 'remuneration', both words refer to the same concept and all references in the Corporations Act to the remuneration of directors and executives is taken as referring to compensation as defined and explained in this Standard.

CSA notes that the accounting standard contains considerable detail and that the accounting profession, the legal profession, those responsible for reporting to shareholders, investors themselves and governance advisers are all familiar with the definition. CSA believes that it would add unnecessary complexity if there were yet another definition.

CSA recommends retaining the existing definitions of remuneration, not adding to them, and ensuring consistency in any legislation dealing with remuneration.

Executive

Currently, s 300A of the Corporations Act requires that the remuneration report discloses remuneration details for the following individuals:

- if the company is part of a consolidated group, each member of the group's key management personnel, its five most highly remunerated company executives and its five most highly remunerated group executives, and
- if the company is not part of a consolidated group, each member of its key management personnel, and its five most highly remunerated company executives.

Key management personnel is defined in AASB 124 *Related party disclosures* as persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

The term 'company executive', in the context of the five most highly remunerated executives, refers to the secretary or people who make decisions which affect the whole or a substantial part of the company's business or have the capacity to affect the company's financial standing.

The identification and determination of who are the key management personnel and the five most highly remunerated executives are already a source of some difficulty for companies. The definitions are challenging to apply in practice. In particular, identifying the key management

personnel and the five most highly remunerated executives may be made difficult in the context of executives changing roles or leaving or commencing employment part-way through the year and because categorisation depends on actual responsibilities and influence rather than role descriptions and reporting lines. For example, a termination payment to an employee of many decades' service, with attendant accrued legal entitlements (annual leave, long service leave etc), could see the employee meet the requirements of the definition of one of the five most highly remunerated executives for the purposes of the remuneration report. Yet the individual may not be a member of the senior executive team.

CSA points to the need to avoid additional complexity by adding any further definition of executive to those already in place. A simplification of the existing definitions would be helpful to reduce some of the difficulty referred to above.

CSA recommends retaining or simplifying the existing definitions of executive and not adding to them.

Applicability of reviews of financial sector on this question

The Australian Prudential Regulation Authority (APRA) has completed a review, as requested by the Prime Minister in 2008, to ensure that executive remuneration in APRA-regulated financial institutions is structured to promote long-term sustainability and avoid perverse incentives. APRA has issued draft revised prudential governance standards that look beyond the senior executive team to other staff. The draft revised standards require that the remuneration policies of the financial institutions that APRA regulates cover all employees and agents, whether or not they are employees of the regulated institution, whose actions could put the institution's financial soundness at risk. This includes 'responsible persons' (generally the senior executive team), risk and financial control personnel and any other personnel who receive a significant proportion of variable remuneration through bonuses, commissions and the like.[5]

However, CSA notes that the terms of reference from the government to APRA specifically focused on whether there is a link between incentive structures and risk taking within the context of whether there should be a link between risk taking and capital ratios. As the latter issue is specific to financial institutions, **CSA recommends** that the APRA draft prudential governance standards on these issues should not be applied to all companies. The APRA prudential governance standards were designed for financial institutions, based on their specific characteristics, and have never had wider application. The changes made to them reflecting APRA's interest in remuneration policies and structures within financial institutions do not change the inapplicability of the prudential governance standards to all companies and other industry sectors.

APRA has noted that[6], 'Given the accountability inherent in APRA's approach, we can expect quite some community and corporate interest in how influential this regime might be on boards of Australian companies that are not prudentially regulated'. CSA recognises that there will be interest in the revised prudential governance standards issued by APRA (currently in draft form), and that some companies may find that some elements of the proposed APRA regime may be applicable to their circumstances. However, this should be a matter for individual boards to determine and not be imposed by regulation.

---

[5] Australian Prudential Regulation Authority, *Prudential Standard APS 510 Governance — Draft*, May 2009

[6] John Trowbridge, Executive Member, Australian Prudential Regulation Authority, *Executive Remuneration: The Regulatory Debate*, speech to 2009 CGI Glass Lewis and Guerdon Associates 2009 Remuneration Forum, Sydney, 16 March 2009

CSA notes that the European Corporate Governance Forum on Director Remuneration has stated that:[7]

> the remuneration issues related to financial institutions should be distinguished from remuneration issues as general corporate governance issues. Both in terms of the relation between financial incentives and risk taking by the institution and in terms of the relation between executive remuneration and remuneration of employees of the institution, financial institutions have specific systemic characteristics that merit special treatment.

As deposit-takers and lenders, financial institutions make a unique contribution to the wellbeing of an economy, as evidenced by the current global financial crisis. Other companies ought not necessarily be subject to the same level of regulation. Moreover, CSA believes that shareholders and the broader community are most concerned with remuneration of the CEO, the other executive directors and a small number of very senior executives and that this group should form the focus of the Commission's inquiry.

Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

CSA notes that the Australian Government recently released the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 for public consultation. Under these proposed new laws, termination benefits for directors and certain senior executive employees exceeding one year's average base salary will require shareholder approval. This is in line with the calls for reform by shareholders over the past few years, whose concern has been not to determine remuneration but to ensure greater scrutiny of remuneration, including termination payments, and greater accountability.

CSA members agree with the introduction of a limit in relation to termination payments offered as 'golden handshakes'. When those termination payments are granted during or following a period of poor company performance, shareholders can experience considerable disquiet at what is perceived as 'reward for failure'. However, although not attracting publicity, the majority of termination payments are not undertaken in a context of poor company performance. Termination payments also include payments made for retirement, resignation, redundancy and death. Therefore, CSA believes that termination payments will need to carefully balance the legitimate interests of shareholders and executives. Good governance requires a practical and workable outcome.

CSA has concerns with the Bill in its current form. A copy of our submission to the government on the Bill is attached as Appendix A.

Some of the issues we point to in the current draft of the Bill are germane to the questions raised in the Commission's paper concerning the definition of executive. The Bill extends the present laws so they apply to persons holding a 'managerial or executive office' with a company. This means that the legislation will apply to:

- for listed companies, those persons whose details were included in the directors' report (that is, the key management personnel and the five most highly remunerated officers)
- for companies that are not listed (including subsidiaries of listed companies), persons who are directors of the company or who hold any other office connected with the management of the company and are also a director of the company or a related company.

[7] Statement of the European Corporate Governance Forum on Director Remuneration, 23 March 2009

Large listed companies can have hundreds of non-listed subsidiaries in Australia. These subsidiary companies will be subject to the legislation.

The directors of the wholly-owned subsidiaries are often employees of the parent company, such as general managers. These persons are usually not senior at the scale of the parent company and their potential termination payments are not at a level that would concern shareholders in the parent company or the community.

CSA reiterates that shareholders and the broader community are most concerned with remuneration of the CEO, the other executive directors and a small number of senior executives of the parent company.

CSA cannot point to any public benefit to shareholders or the community in imposing a new and onerous regulatory burden on companies that would require shareholder approval of the termination payments of general or middle management. The persons caught by the extended definition in the Corporations Amendment (Improving Accountability of Termination Payments) Bill 2009 are not those whose remuneration has caused any community or shareholder disquiet.

CSA strongly recommends against the definition in the draft legislation of persons holding a 'managerial or executive office' with a company as those to whom the legislation applies.

What constraints exist on the levels of director and executive remuneration?

A number of constraints are already in place on the levels of director and executive remuneration.

1. As noted above, shareholders have the right to remove directors (s 201G and, for public listed companies, s 201E). The ASX Listing Rules require directors of public listed companies to submit themselves to re-election every three years (LR 14.4).
2. Director remuneration is subject to shareholder approval (s 202A). Listing Rule 10.17 requires that total remuneration of non-executive directors cannot be increased without shareholder approval.
3. Shareholders with at least five per cent of the votes that may be cast at a general meeting or at least 100 shareholders have the right to obtain information about directors' remuneration (s 202B).
4. A company may not provide benefits associated with a person's retirement from a board or managerial position without shareholder approval (s 200B(1)). The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 that is currently available for public comment sets out reforms to this section.
5. The remuneration report of a public listed company must be submitted to a general meeting of shareholders and the adoption of that report is subject to a non-binding vote (ss 250R(2) and (3)). The remuneration report must disclose a breakdown of performance-related components, non-performance related components and the value of any securities issued as part of a person's remuneration. If any of those directors or top five paid executives are employed under a contract, the remuneration report must also detail the duration period of the contract, notice periods required for termination and any termination benefits payable.
6. Shareholder approval must be sought for a new issue of shares granted to directors (encompassing executive and non-executive directors) (Listing Rule 10.14). A new issue will dilute the value of existing shareholders' securities by increasing the number of securities on issue while total equity remains unchanged. Listing Rule 10.14 is one of several listing rules that relate to the dilution of shareholdings. These rules effectively state that, where dilution will occur as a result of a significant capital raising or in the context of the issue of new securities to related parties, shareholder approval is required.

7. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (the guidelines) state that 'no individuals should be directly involved in deciding their own remuneration'.[8]
8. Recommendation 8.2 of the ASX Corporate Governance Council guidelines states that, 'Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives'.
9. The ASX Corporate Governance Council's guidelines call for entities to provide disclosure in relation to the entity's remuneration policies.[9]
10. All public listed companies are required to report to shareholders against the guidelines, which operate on an 'if not, why not' basis (Listing Rule 4.10). If companies implement any practices that differ from those recommended by the guidelines they must explain why they do so and the benefit to shareholders.

The Accounting Standards, the Corporations Act and the listing rules contain clear requirements for the disclosure of securities including options, when issued, when exercised and annually (regardless of activity). This adds transparency, and accountability, to the process.

Continuous disclosure

Australia has a continuous disclosure regime in place for public listed companies. In essence, this means that the opportunity exists for shareholders to receive continuous and near real-time information that is material to the share price performance of the company.

Where companies enter into employment agreements with key executives, continuous disclosure obligations under Listing Rule 3.1 may be triggered. Listing Rule 3.1 requires that where any listed entity becomes aware of information which a reasonable person would expect to have a material effect on the price or value of the entity's securities, then the entity must disclose that information to the market (subject, of course, to any exceptions and carve-outs contained in the Listing Rules).

Where a chief executive officer is appointed (or where a managing director is appointed to a company that does not have a chief executive officer) Listing Rule 3.1 will require that a summary of the terms and conditions of employment be disclosed.

The ASX has set out some examples of what type of information entities may disclose upon a CEO's appointment, which include:

- what proportion of pay is base pay
- what proportion of pay is related to performance (and the applicable time frames)
- what proportion of pay is related to share price (and the applicable time frames)
- what proportion of pay is equity based, and
- whether there are any add-ons for longevity.

Companies are also expected to disclose any other components of remuneration and the nature of termination entitlements. The disclosure does not necessarily need to include dollar amounts, although in practice most companies choose to include dollar amounts.

In addition to this requirement, the ASX Corporate Governance Council's guidelines call for entities to provide disclosure in relation to the entity's remuneration policies to enable investors to understand the cost and benefits of those policies and the link between remuneration paid to directors and key executives and corporate performance.

---

[8] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, Principle 8: Remunerate fairly and responsibly, p 35

[9] As above, p 37

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?

CSA notes that commentary on executive remuneration tends to compare the highest remuneration extended to senior executives, particularly the CEO, with the lowest remuneration extended to employees in very junior positions. Such comparisons excite considerable disquiet at the disparities in the levels of remuneration.

However, CSA notes that there are differing levels of remuneration extended to a range of employees between these two bands. When the levels of remuneration in a large public listed company are reviewed at each band of employment, the disparity between each band is usually not extreme. Virtually all of this information is not publicly available and generally not well understood. CSA notes, therefore, that caution is required when the Commission is determining its recommendations about relativities between employees.

There is a relationship between director and executive remuneration and that of other employees. In most large companies, performance plans are in place providing incentives to employees at all levels to achieve agreed targets. Key performance indicators (KPIs) will differ from company to company, but both short-term and long-term incentives (STIs and LTIs) as motivations for achievement are common. Frequently, directors will determine that those executives whose decisions have an impact on financial results will be on the same or a similar performance plan as the CEO. While the next most senior executives may not be on the same plan, directors typically have regard to relativities, in order to motivate employees and for reasons of internal equity.

Directors usually determine the specific remuneration of the CEO and the top executives reporting to the CEO and focus more broadly on the remuneration of other employees. The incentive plans of large companies often apply to many other executives and it is common for the board to approve participation in these plans. In considering this participation, directors usually have regard to remuneration of the participating employees at all levels, and the relativities between them.

In all companies there must be an appropriate link between the items on which employees (executives or otherwise) are being rewarded and the actions they are able to take to influence the desired outcomes. Clearly, senior executives have relatively large decision rights that enable them to have relatively greater influence over the company's desired outcomes.

Directors also usually take into account any external information that may be available concerning employee remuneration at different levels, for example, competitor companies.

How should the Commission determine what is 'justified' — what tests should be applied?

CSA reiterates that the board is best placed to determine executive remuneration. CSA does not believe that shareholders are in a position to determine executive remuneration, as it would be a decision taken in isolation from the broad range of decisions concerning the operational and financial performance of a company. Nonetheless, CSA believes that shareholders do have a role in scrutinising remuneration decisions, holding directors accountable for their decisions and, ultimately, determining whether directors should remain on the board.

Disclosure of remuneration is intended to provide shareholders with an appropriate level of scrutiny of director and executive remuneration as well as an appreciation of the risks inherent in such arrangements. The disclosure should contain sufficient detail to enable shareholders to understand fully the components of directors' and executives' remuneration as well as progress towards the achievement of previously granted awards.

CSA believes that it is for shareholders to test directors' thinking and behaviour through shareholder engagement and for boards to be accountable to justify their decisions to shareholders. Each company is unique and its circumstances may change dramatically and suddenly. Companies need the freedom to organise themselves and respond most effectively to the needs of the day. Remuneration needs vary considerably between companies and over time within a particular company. A centralised, regulated approach for setting remuneration will deprive companies of the ability to respond most effectively to the needs of the day, and almost certainly will drive inefficiencies and unwanted outcomes. It would steer Australian director and executive common law contracts of employment towards an industrial awards and agreement system, which would impair Australian corporate competitiveness globally.

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?

The relationship between levels of remuneration and individual and corporate performance is different for each corporation and also differs over time for each corporation. For example, retention of employees could be important in one period, while hiring the right person or people in a difficult environment could be the most important consideration at another time. The consideration of what is required for corporate performance cannot be effectively prescribed by regulation.

Remuneration committees and boards focus on the key value drivers in the business environment, the general behaviour and strategy of companies competing for similar executive talent and the likely prospects of the enterprise in the near term. These need to be compared with the market generally when setting remuneration.

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

Motivation is a complex concept. Remuneration is also complex. For most companies, remuneration is a critical tool for driving the desired performance outcomes. Nevertheless, research shows that employees at all levels value recognition, learning, discretion, and a worthwhile job above increased remuneration.

Human resource management theory often points to research showing that feelings of job satisfaction are more important than money in persuading people to increase productivity.[10] However, this needs to be balanced by other research specifically conducted with directors[11] that found that directors *are* motivated by money, and not by job satisfaction, as they have all the job satisfaction they need or want.

---

[10] F Herzberg, B Mausner and B Snyderman, *The Motivation to Work*, NY, John Wiley & Sons, 1959

[11] Manfred Davidmann, *Work, Remuneration and Motivation of Directors,* Social Organisation Ltd, 1970

Other key motivating factors for non-executive directors are the desire to contribute their knowledge and skill, earned over many years, to the success of an enterprise, as well as ensuring that their reputation is not negatively affected in so contributing.

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?

Director and executive share ownership was introduced in Australia in response to shareholder activism, which sought to ensure that the interests of directors, executives and shareholders were aligned. The Investment and Financial Services Association's guidelines for listed companies on corporate governance specifically states that 'The board should establish and disclose in the annual report a policy to encourage non-executive directors to invest their own capital in the company or to acquire shares from an allocation of a portion of their fees' [12].

In the last two decades, the introduction of variable pay, both in cash and in shares and rights to acquire shares, became the favoured model to help align the interests of executives with the interests of shareholders of listed companies.

Shareholders expressed concern that a large base pay with few incentives would mean that executive remuneration was not aligned with investor interests. This earlier concern has now been replaced by concern in some instances that bonuses based on STIs are not truly at risk, which in turn represents a misalignment of executive and investor interests.

Shareholders generally accept that bonuses based on LTIs are at risk, as in volatile times when companies do not meet financial targets, those bonuses are not paid, whereas in buoyant economic periods when financial targets are achieved, the bonuses are paid. Shareholders can see that the interests of executives are aligned with theirs when reviewing LTIs, as executives do not receive the same levels of remuneration when the business is not performing well. Leaving aside termination payments, current shareholder focus is, therefore, for the most part, aimed at ensuring the right balance between base pay, STIs and LTIs.

CSA notes that, currently, in some companies, boards are already capping remuneration or putting in place different STIs and LTIs in order to enhance the alignment of executive and investor interests. In relation to capping remuneration, boards must contend with the need to ensure that the fixed component of remuneration is a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy. If the fixed component (base salary) is low the company will find it difficult to cut or eliminate a bonus in a poor financial year. A measure of the effectiveness of this principle would be the ability of a company to be able to pay no bonus in a year in which the company makes a loss.

APRA's draft revised prudential governance standards[13] require boards to implement remuneration policies that ensure that the design of performance-based remuneration arrangements allows for adjustments to reflect the risks arising from the business activities in

---

[12] Investment and Financial Services Association, *IFSA Guidance Note No. 2.00 Corporate Governance: A Guide for Fund Managers and Corporations, May 2009, at 10.3: Guideline 2 – Communication with companies, p 15*. This Guide is commonly known as the IFSA Blue Book.

[13] Australian Prudential Regulation Authority, *Prudential Standard APS 510 Governance — Draft*, May 2009

which the individual is engaged; the controls in place to mitigate those risks; the time necessary for the outcomes of those business activities to be reliably measured; and the capital allocated to those business activities. The draft standards require that performance-based remuneration arrangements include measures of performance, the mix of forms of remuneration (such as fixed and variable components, and cash and equity-related benefits) and the timing of when the individual becomes eligible to receive payment. The draft standards also require that the remuneration policy must enable the board to reduce or eliminate payment of performance-based remuneration where such actions are necessary to protect the financial soundness of the regulated institution; or deferred performance-based remuneration, where adverse outcomes that arise during any deferral period lessen the original assessment of the performance generating the deferred allocation.

The Financial Services Authority in the United Kingdom released its draft code of practice on remuneration policies in March 2009, which states that:[14]

> Assessments of financial performance to calculate bonus pools should be principally based on profits. The bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required. Firms should not assess performance solely on the results of the current financial year…Profits from banking activities are volatile and subject to cycles. The financial performance of firms and individual employees can be exaggerated as a result. The assessment process should include measures to ensure that employees are assessed on their longer term performance….Performance assessment on a moving average of results can be a good way of meeting the requirements of this criterion, however, other techniques, e.g. good quality risk adjustment… and deferment of a sufficiently large proportion of remuneration…. can be used.

CSA notes again that issues that have arisen in the finance sector are not generally applicable to all companies. In companies outside the financial sector CSA strongly believes that it is for boards to determine the appropriate level of risk taking for the companies they govern.

Why and/or when are the dealings between shareholders and companies on remuneration issues a matter of public interest? What relationship exists between the structures of remuneration and individual and corporate performance? What are the key drivers of performance for directors and executives?

Western states have a long history of involvement in the formation of corporations. The corporation comes into existence due to the special concession of the state. A corporation seeks to trade and raise capital by means of public share issues and is, therefore, by definition a public entity that should be regulated to some degree by the state in the public interest. The dealings between shareholders and companies are one element in this regulation.

In relation to director decision making, directors have fiduciary duties to control the destiny of the company not for their own benefit but rather for the benefit of shareholders, while taking into account the reasonable expectations of other stakeholders with an interest in the company's affairs. Directors are the stewards of the company's property and operations and they are accountable for that stewardship. They have statutory duties to act in good faith and for a proper purpose in the best interests of the company. Their statutory responsibilities to act with care and diligence, not misuse position or information and avoid placing themselves in a position of conflict where personal interest or duty conflicts with their duty to the company reside under these overarching duties.

---

[14] Financial Services Authority, *FSA draft code of practice on remuneration policies*, 18 March 2009

Civil and criminal penalties attach to these duties. The corporate regulator, the Australian Securities and Investments Commission (ASIC) has taken action against directors and executives for breaches of these duties.

The important point is that directors are not making decisions in a vacuum. Their duties and responsibilities attach to all director behaviour, including that related to remuneration decision making.

The question posed in the issues paper concerning whether dealings between shareholders and companies on remuneration is a matter of public interest is already dealt with in corporate law, which is the mechanism by which entities are regulated in the public interest. In terms of the social responsibility of companies, both the CAMAC report and the PJC report found that no further revision of the Corporations Act was required to clarify the extent to which directors may take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions. As noted in the CAMAC report, 'the established formulation of directors' duties allow directors sufficient flexibility to take relevant interests and broader community considerations into account. Changes of a kind proposed from time to time do not provide meaningful clarification for directors, yet risk obscuring their accountability'.[15]

The relationship between the structures of remuneration and individual and corporate performance

As noted earlier, the relationship between levels of remuneration and individual and corporate performance is different for each corporation and also differs over time for each corporation. For example, retention of employees could be important in one period, while hiring the right person or people in a difficult environment could be the most important consideration at another time. The consideration of what is required for corporate performance cannot be effectively prescribed by regulation.

Key drivers of performance

As noted earlier, motivation is a complex concept. For most companies, remuneration is a critical tool for driving the desired performance outcomes. Nevertheless, research shows that employees at all levels value recognition, learning, discretion, and a worthwhile job above increased remuneration. Other key motivating factors for non-executive directors are the desire to contribute their knowledge and skill, earned over many years, to the success of an enterprise, as well as ensuring that their reputation is not negatively affected in so contributing.

---

[15] Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations: Report*, December 2006; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate responsibility: Managing risk and creating value*, 21 June 2006, p 7

Section 2: Effectiveness of regulatory arrangements

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?

Section 201J provides that the directors appoint the managing director of the company and determine the terms and conditions of that appointment.

In many companies the senior staff member is a chief executive, and not a member of the board as is a managing director.

Existing regulatory framework
As noted in Section 1, considerable regulation already exists in relation to director and executive remuneration.

- Director remuneration is subject to shareholder approval (s 202A).
- Shareholders with at least five per cent of the votes that may be cast at a general meeting or at least 100 shareholders have the right to obtain information about directors' remuneration (s 202B)
- The remuneration report of a public listed company must be submitted to a general meeting of shareholders and the adoption of that report is subject to a non-binding vote (ss 250R(2) and (3)).
- Shareholder approval must be sought for a new issue of shares granted to directors (encompassing executive and non-executive directors) (Listing Rule 10.14).
- Shareholders have the right to remove directors (s 201G and, for public listed companies, s 201E). The ASX Listing Rules require directors of public listed companies to submit themselves to re-election every three years (Listing Rule 14.4).
- The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (guidelines) states that 'no individuals should be directly involved in deciding their own remuneration'[16] and Recommendation 8.2 states that 'Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives'.
- All public listed companies are required to report to shareholders against the guidelines, which operate on an 'if not, why not' basis (Listing Rule 4.10).
- Where a chief executive officer is appointed (or where a managing director is appointed to a company that does not have a chief executive officer) Listing Rule 3.1 will require that the terms and conditions of employment be disclosed.
- Where companies come into employment agreements with key executives, continuous disclosure obligations under Listing Rule 3.1 may be triggered.
- The ASX Corporate Governance Council's guidelines call for entities to provide disclosure in relation to the entity's remuneration policies.[17]

Additional regulation will not help
CSA firmly believes that no further regulation of director and executive remuneration will assist boards in fulfilling their responsibilities to engage a chief executive or managing director and other key executives, including associated terms and conditions, consistent with shareholder interests.

---

[16] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, Principle 8: Remunerate fairly and responsibly, p 35
[17] As above, p 37

CSA recommends that the substance of director and executive remuneration should not be regulated in a mandatory way. It is for companies and their shareholders to continue to determine what pay structure and levels are appropriate for their directors and executives in light of their particular circumstances and different practices.

Good practice for boards

CSA believes that boards and relevant remuneration committees should exercise independent judgment and demonstrate that their decisions are consistent with the interests of shareholders and the company's financial situation and future prospects. The members of boards and their relevant remuneration committees should have the skills and experience to reach an independent judgment on the suitability of the remuneration policies, including the implications for risk and risk management.

The ASX Corporate Governance Council guidelines recommend that:[18]

> the remuneration committee should be structured so that it:
> - consists of a majority of independent directors
> - is chaired by an independent director
> - has at least three members.

CSA also believes that the procedures for setting compensation within the company should be clear and documented, and they should include measures to avoid conflicts of interest.

CSA believes that it is good practice for boards to:

- clearly articulate the board's remuneration philosophy and the process by which it determines executive remuneration
- engage with shareholders and clearly explain the company's remuneration framework, the rationale for the framework and the outcomes it produces
- structure incentives to drive performance that rewards shareholders over the long term
- take accountability for their remuneration decisions, including in response to feedback from shareholders through votes on the remuneration report
- ensure that there is a clearly agreed contractual right to terminate the CEO and any senior executives appointed by the board
- ensure that the contractual rights for CEOs and executive directors are fully disclosed to shareholders
- ensure that all vesting rights attaching to equity incentives are publicly disclosed at the time the CEO enters into a contract
- ensure, where an executive departs prior to a vesting date, that long-term incentives are limited on a pro-rata basis to the period served and that any entitlements are measured as far as possible on the original performance targets
- not shirk their responsibilities to dismiss poor performers without additional payments.

Clawback provision in contract

CSA recommends that the company should reserve the right, at the discretion of non-executive directors to:

- reclaim performance-linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice (a 'clawback' provision)
- not make such payments if the results are found to be manipulated.

---

[18] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, Principle 8: Remunerate fairly and responsibly, p 35

Disclosure
It can be argued that disclosure has led to upward pressure on remuneration. Boards benchmark the remuneration of executives with the remuneration of executives of companies in a peer group, as this information is publicly available. Combined with the practice of aiming to reward executives at the median or upper quartile of such peer group, an autonomous upward pressure ('ratchet effect') on the remuneration of executives of all companies is created, which has no relation to the underlying performance of these companies or the personal performance of the executives.

CSA strongly supports principles-based disclosure and believes that disclosure underpins the operation of the market in Australia. However, the role that disclosure has played in creating upward pressure on director and executive remuneration needs to be acknowledged as an unintended consequence of the increased disclosure requirements.

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?

Australian listed companies operate in a disclosure regime, and directors have considerable accountability requirements they are obliged to meet, as set out above.

Boards are very aware of the importance of tying executive remuneration to company performance. In the buoyant market of the past decade, company performance was often measured by a range of factors, including market capitalisation. As market capitalisation rose, so did levels of remuneration. However, the business was not of itself necessarily harder to run.

In the current climate of a bear market, with market capitalisation decreasing, businesses are not easier to run — if anything, they may be harder to run — yet existing arrangements tying remuneration should now tend to drive down remuneration packages. These arrangements cannot necessarily be swiftly changed to reflect changed market circumstances. Decisions that have been taken a few years ago in different market conditions cannot be unbundled at a moment's notice as market conditions shift rapidly.

CSA believes that it is important not to regulate in response to changes in market cycles. While it is entirely appropriate for shareholders to review remuneration plans and structures and provide feedback on them, introducing regulation on remuneration as a response to a downturn can have unintended negative consequences as the market begins to pick up again. Regulation is a 'sledgehammer' technique for dealing with matters that are best left to dialogue and engagement between shareholders and boards.

Already the Australian market has witnessed decreases in executive remuneration at companies previously noted for their high levels of remuneration, For example, while the Macquarie Bank remuneration scheme is complex, the May 2009 disclosures show that it is aligned with the changed performance of the group. In many instances, boards are reviewing whether tying company performance to market capitalisation is an appropriate measure. Boards are also putting in place freezes and caps on remuneration.

Institutional investors and the Australian Shareholders' Association (ASA) on behalf of retail shareholders have been engaging with boards on compensation packages for some years. Shareholders can vote on the remuneration report, which is a vote on the remuneration policy of the company, and any material change to it. One disadvantage of the shareholders' vote is its binary nature. Shareholders who approve of a company's overall remuneration strategy might feel compelled to vote against it because they dislike a single element.

Investor engagement with boards on remuneration since the introduction of the non-binding shareholder vote in 2005 on the remuneration report has seen marked changes in the remuneration structures at companies where shareholders had concerns with remuneration plans. There are approximately 1,800 listed companies in Australia. In the four years of operation of the non-binding shareholder vote, 25 listed entities have received a no vote of more than 20 per cent on the remuneration report.[19] Of those, only three entities have twice received a no vote of more than 20 per cent, revealing that shareholder engagement and pressure was successful in modifying board behaviour.

Corporate behaviour has already been modified in response to investors engaging with boards and discussing matters of concern. The non-binding shareholder vote is a blunt instrument, but nonetheless, a high negative vote on the remuneration report sends a strong signal to directors. In the majority of instances, directors have responded by making changes to accommodate the wishes of investors.

CSA believes that such voluntary changes in remuneration practices reflect the efficacy of the current arrangements for directors and executives under the Corporations Act, the ASX listing rules and the ASX Corporate Governance Council guidelines. We understand that some parties are entering this debate with assumptions that further regulation is required, but CSA does not believe that it is.

Transparency

The current arrangements have provided greater transparency for investors, and this in turn means fewer surprises and more opportunities for dialogue and engagement. Communication between companies and investors is not a matter of information alone. It is also about building relationships, and providing clarification on both sides as to why decisions are made and in what context.

Governance advisers and proxy advisory services note that the companies that receive shareholder approval of their decisions concerning remuneration plans and structures engage their investors early, providing a context and rationale for their decisions. Conversely, companies that struggle to achieve shareholder approval often leave communication to the last minute, providing no time for dialogue, or they do not conduct a dialogue at all.

Greater transparency will not of itself improve engagement. This can only be achieved by investors, both institutional and retail, taking an active position with those companies that do not engage at present. As noted by the Australian Council of Superannuation Investors:[20]

> Once the decision to invest in a company has been made, the [superannuation] fund can influence the board to ensure that the company is managed effectively for the long-term interests of shareholders … The means of influence are:
>
> - exercising the vote attached to the shareholding and
> - engaging with directors and executives on issues arising in a company.
>
> There is also a key influence to not invest or deinvest.

---

[19] *The Mayne Report*, January 30, 2009

[20] Ann Byrne, 'Investing for the longer term — ensuring all risks are accounted for', *Keeping good companies*, Vol 61, No 4, p 205

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?

One of the key barriers to effective shareholder engagement, particularly for retail shareholders, is information overload. It is not unusual for the statutory remuneration reports of large listed companies to run to 20 pages or more of detailed disclosures which can be largely impenetrable to the lay reader. The statutory requirements attached to the remuneration report are such that companies requires substantial legal advice to ensure that all requirements are met — this in turn means that remuneration reports are often highly legalistic.

A highly legalistic remuneration report does not tell the company's story in its own words and can hinder understanding on the part of the investor. Investors are seeking information as to why certain decisions concerning remuneration have been made, in what context and for what purpose. The remuneration report needs to tell the 'why' as well as the 'what' of remuneration decisions.

CSA recommends that the legislation governing the remuneration report be reviewed, to assess if the level of statutory information required could be streamlined to assist disclosure.

As legislative reform can progress slowly, and public consultation on any changes to the legislation governing the remuneration report will be required, CSA notes that, in the meantime, companies with complex remuneration structures could be encouraged to consider issuing short-form remuneration reports to shareholders. Companies should be left to communicate directly with their shareholders as to what form of non-statutory reports shareholders would like to receive, and such short-form reports should remain non-statutory.

There is a precedent for this.

The Corporations Legislation Amendment (Simpler Regulatory System) Act 2007 introduced amendments to the Corporations Act to allow companies to elect to distribute annual reports by making them available on their websites, subject to certain administrative requirements. Companies can make annual reports available on the internet, with hard copies provided only on request. This change to the law:

- provided shareholders with greater flexibility as to what information they wish to review, given that the information needs can differ substantially between individual shareholders and groups of shareholders (such as retail and institutional shareholders)
- ensured that companies can engage more meaningfully with their shareholders. With shareholders able to view parts or all of the information required by statute on the website, companies have the opportunity to send shareholders non-statutory reports effectively communicating a company's market, strategy and investment proposition.

The concise report was originally introduced into the Corporations Act to facilitate such communication, but increased regulation saw the concise report increase dramatically in length, such that it no longer met the needs of shareholders.[21] The increased length of concise reports, and the recognition by companies that the majority of shareholders want only specific and very

---

[21] Research conducted into the top 200 listed companies by CSA over a number of years showed a declining number of shareholders electing to receive the full annual report, with only 10 per cent of shareholders in large listed companies wishing to receive the hard copy of the annual report, and only 10 per cent electing to receive it by email. Of those 20 per cent of shareholders who elected to receive the annual report, 71 per cent of them elected to receive the concise annual report. That is, only seven per cent of shareholders in large listed companies elected to receive the concise annual report. All statistics taken from *Benchmarking Governance in Practice in Australia 2008,* published by CSA.

concise information, led some companies to seek additional means of communication with their shareholders, such as introducing short-form non-statutory reports.

Many of the large listed companies now issue short-form reports, and they find that the majority of their shareholders request these rather than the full annual report (on average, only ten per cent of shareholders request the full annual report in hard copy).[22] The full report remains available to all shareholders on the website. Thus the capacity to issue meaningful information to shareholders has seen the demise of the statutory concise report.

The high success of such initiatives highlights that no *further* regulation is required in relation to remuneration reports, as regulation is likely to lead to the return of regulatory information overload, rather than meeting the information needs of shareholders. The full remuneration report would continue to be available to all shareholders, but a non-statutory, short-form report provides the opportunity for companies with complex remuneration structures to tell their own story and explain the 'why' as well as the 'what' of remuneration. It would ensure that such short-form reports are non-legalistic.

CSA also recommends that it can be useful for companies to align the bonuses payable in the year dealt with in the remuneration report with the financial year to which the remuneration report is attached. A mismatch of payment dates and reporting dates can lead to misunderstandings. CSA recommends that companies recognise the entitlement has arisen even if the bonus is actually paid in the subsequent year, in order to avoid misunderstanding.

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?

CSA believes there is an appropriate balance between legislated requirements and voluntary guidelines.

It is also important to consider what is meant by voluntary guidelines. Reporting against the ASX Corporate Governance Council's guidelines is not voluntary. All public listed companies are required to report to shareholders against the guidelines, which operate on an 'if not, why not' basis (Listing Rule 4.10). This means that companies are free to put in place remuneration arrangements that differ from those recommended by the guidelines, but must explain to investors why they believe their arrangements are in investors' interests.

There is strong investor support for the 'if not, why not' regime of the ASX Corporate Governance Council's guidelines, specifically because it assists investors to understand board decision making about governance arrangements, including remuneration.

Other voluntary guidelines exist, such as the Australian Institute of Directors' (AICD) *Executive Remuneration: Guidelines for listed company boards*.

CSA recommends that companies put in place a structure of review and authorisation designed to ensure the factual and explanatory presentation of the remuneration report. Such a structure would include review and consideration of the remuneration report by the remuneration committee, reporting by the remuneration committee to the board on all matters relevant to the committee's role and responsibilities and sign-off by the remuneration committee of the remuneration report as part of the annual report. It would not diminish the ultimate responsibility of the board to ensure the factual and explanatory presentation of the remuneration report. The remuneration committee chairman would sign the remuneration report

---

[22] Chartered Secretaries Australia, *Benchmarking Governance in Practice in Australia 2008*, April 2008, p 4

in the annual report. Leading companies already have such a review and authorisation process in place. CSA does *not* recommend that this process be mandated.

CSA also recommends that the chairman of the remuneration committee be available to speak to the remuneration report at the AGM.

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

CSA does not believe that introducing new regulation will assist in providing greater transparency and accountability on director and executive remuneration or fostering greater shareholder engagement. CSA notes that the current market conditions are fluid and regulating remuneration at a time when boards are seeking to review and revise remuneration plans and structures to accommodate changed market conditions is unhelpful.

CSA notes that Australian companies and financial institutions have *not* been the subject of taxpayer-funded bailouts to the degree that they have been in the United States. In the United States and the United Kingdom, respective governments have taken equity positions in many of their major banks. This did not occur in Australia.

CSA believes that if the government becomes a full or part owner of a company and wishes to attach conditions to such taxpayer-funded assistance it may do so on any terms it sees fit.

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?

CSA reiterates that it does not believe that the current governance regime is broken and needs repair. On this basis, CSA sees no need to adopt a code of practice.

CSA notes that it is always useful to review developments in other jurisdictions. However, CSA does not believe that guidelines and codes of practice introduced in other jurisdictions would significantly improve the arrangements or regulation of director and executive remuneration in Australia. Moreover, CSA notes that most codes of practice that have been introduced overseas relate specifically to the financial sector. APRA is already reviewing practices in this sector in Australia.

The international guidelines and codes of practice that are useful to consider *for information only* include:

United Kingdom
The Financial Services Authority (FSA) in the United Kingdom has introduced a Code of Practice on remuneration policies, but this applies only to financial institutions. The principles embodied in the Code are not concerned with levels or quantum of remuneration, which the FSA believes are a matter for firms' boards, but aim to ensure that firms have remuneration policies which are consistent with sound risk management, and which do not expose them to excessive risk. This is in line with the review being undertaken by APRA in Australia, the outcomes of which will be applicable to financial institutions only and not companies in general.

Europe
The European Commission has adopted a Recommendation on the regime for the remuneration of directors of listed companies, complementing previous Recommendations that were based on pay for performance through disclosure of the remuneration policy. The new

Recommendation provides further guidance on achieving this by setting out best practices for the design of an appropriate remuneration policy. It sets a two-year maximum of the fixed component of directors' pay on severance and bans severance pay in case of failure. This is one year more than the limit set in the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

It recommends a balance between fixed and variable pay and linkage of variable pay to predetermined and measurable performance criteria to strengthen the link between performance and pay. This accords with the guidance set out in Principle 8 of the ASX Corporate Governance Council's guidelines.

It recommends promoting the long term sustainability of companies through a balance between long and short-term performance criteria of directors' remuneration, deferment of variable pay, a minimum vesting period for stock options and shares (at least three years); and retention of part of shares until the end of employment.

It also recommends allowing companies to reclaim variable pay paid on the basis of data, which proved to be manifestly misstated ('clawback'). CSA has already recommended that boards include clawback provisions in contracts with CEOs and other senior executives.

The Recommendation also suggests that companies provide that non-executives should not receive share options as part of their remuneration to avoid conflict of interests. Principle 8 of the ASX Corporate Governance Council's guidelines already provides guidance that non-executive directors should not receive options or bonus payments.

The Recommendation further suggests strengthening the role and operation of the remuneration committee through new principles on (i) the composition of remuneration committees; (ii) the obligation for the members of the remuneration committee to be present at the general meeting where the remuneration policy is discussed in order to provide explanations to shareholders; (iii) avoiding conflicts of remuneration consultants.

Remuneration committee composition is already dealt with in Principle 8 of the ASX Corporate Governance Council's guidelines. CSA comments on the other matters elsewhere in this submission, recommending that the chairman of the remuneration committee speak to the remuneration report at general meetings and recommending that best practice for boards would be to appoint their own remuneration adviser to review the remuneration package for senior executives put forward by management.

The new Recommendation is based on best practices found in member states' legislation or various national corporate governance codes in Europe. It is not legally binding and member states are free to decide whether to implement it or not.

The Recommendation operates on the 'comply or explain' principle — this matches the 'if not, why not' principle at the heart of the ASX Corporate Governance Council's guidelines.

Financial Stability Forum (FSF)

FSF Principles for Sound Compensation Practices are intended to apply to significant financial institutions. They will be reinforced through supervisory examination and intervention at the national level. They are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are not intended to prescribe particular designs or levels of individual compensation. This is in line with the review being undertaken by APRA in Australia, the outcomes of which will be applicable to financial institutions only and not companies in general.

G20

In April 2009, the 20 largest economies in the world pledged to strengthen financial supervision and regulation by making it more globally consistent. According to the final communiqué from the G20 summit, held in London, the strengthened regulatory system will 'promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking'.

The G20 set out a number of methods by which this will be achieved, one of which is endorsing and implementing the FSF's new principles on pay and compensation, and supporting sustainable compensation schemes.

The model recommended by the G20 is essentially the model currently in operation in Australia.

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?

Extent of use of remuneration committees

Recommendation 8.1 in the ASX Corporate Governance Council's guidelines state that 'the board should establish a remuneration committee'. The guidelines provide commentary on the purpose, charter, composition and responsibilities of the remuneration committee.

Under Listing Rule 4.10, all public listed companies must report to shareholders on an 'if not, why not' basis as to their alignment with the Recommendations in the guidelines (Recommendation 8.3 specifically deals with companies reporting against Recommendation 8.1). 'If not, why not' reporting involves an entity identifying the Recommendations it has not followed, explaining why it has not followed the relevant Recommendation, explaining how its practices accord with the 'spirit' of the relevant Principle, and explaining that it understands the relevant issues and has considered the impact of its alternative approach.

In relation to reporting on the establishment of remuneration committees, the 2008 ASX report noted that:

> The overall reporting level for listed companies [for the Recommendation to establish a remuneration committee] in 2007 increased by 1% to 96% — 58% of listed companies adopted the Recommendation and 38% reported on an 'if not, why not' basis. There was a 2% decrease in the number of listed companies adopting the Recommendation and a corresponding 2% increase in the number of listed companies 'if not, why not' reporting. The overall reporting level for listed trusts in 2007 increased by 10% to 92%. In 2007 41% of listed trusts adopted the Recommendation, compared to 24% in 2006 and there was also a decline in the level of 'if not, why not' reporting for listed trusts for this Recommendation to 51% in 2007 from 58% in 2006.

These figures show that in the listed sector, the use of remuneration committees is significant and extensive.

Most frequently, where smaller listed companies do not have sufficient directors to constitute a remuneration committee matching the recommended composition requirements as set out in the guidelines, they implement good governance practices to ensure that they can achieve the necessary oversight of a remuneration committee. The directors will meet separately to board meetings as a remuneration committee. The committee will have its own terms of reference which are then approved by the board. The terms of reference provide that the chairman of the committee will be a director other than the chairman of the board. Separate minutes of the meetings are taken by the company secretary and information is prepared and brought forward

in a format different from how it is usually presented to the board. The minutes are tabled at the next board meeting and they are addressed as an agenda item.

Linkages
CSA believes that the introduction of the recommendation to have a separate remuneration committee, along with the recommendation for that committee to implement terms of reference that clearly set out the role and responsibility of the committee to link remuneration levels and individual and corporate performance, has brought considerably more focus and professionalism to how boards manage executive remuneration. It is to be expected that this enhanced focus would improve the linkages between remuneration levels and individual and corporate performance, but it would be difficult to obtain empirical evidence to support this without dedicated analysis.

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?

CSA believes that it is inevitable that conflicts of interest will arise in the arrangements by which remuneration consultants advise on director and executive remuneration. Remuneration consultants may provide services in addition to those attached to remuneration advice and may have prior relationships with senior executives or directors.

On the matter of managing conflicts of interest with remuneration consultants, **CSA recommends that it is best practice** for boards to:

- engage their own remuneration adviser to review the remuneration package for senior executives put forward by management and remuneration consultants appointed by management
- ensure their remuneration adviser is appointed by and solely accountable to the remuneration committee
- disclose in the annual report the names of the remuneration consultants, whether they were appointed by the remuneration committee and the types of services they provide to the company.

CSA does not believe that additional regulation is required in this area.

Section 3: The role of institutional and retail shareholders

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?

CSA reiterates that it supports current corporations legislation, in Australia and other common law countries, that clarifies that the business of a company is to be managed by or under the direction of a board of directors appointed by and accountable to the shareholders, and the directors exercise all powers of a company except those that are required to be exercised in a general meeting.

On the issue of remuneration, CSA strongly believes that directors should have the responsibility to determine executive remuneration. CSA does not believe that shareholders should be determining remuneration. However, CSA does believe that shareholders should have the capacity to hold directors accountable for their decisions on remuneration.

As well as the existing shareholder right to elect and remove directors, the non-binding shareholder vote on the remuneration report provides an opportunity for shareholders to hold boards accountable for their decisions on remuneration. It not only provides the opportunity for shareholder scrutiny of board decision making on remuneration, but also the opportunity to express shareholder views and engage with boards, without blurring the line between managers and owners.

The chief executive of the Australian Council of Superannuation Investors has commented that:[23]

> In ACSI's experience, the introduction of a non-binding shareholder vote on a company's remuneration report in the CLERP 9 reforms has been one of the single biggest catalysts for improved levels of engagement between institutional shareholders and company directors. The remuneration report has provided a basis for companies to explain the rationale of their approach on pay, and the non-binding vote has given shareholders an opportunity to express their views. From an investor's perspective, the 'say on pay' is one of our most significant ways to ensure that the board is managing the CEO and their team for the benefit of shareholders.

Regulation providing shareholder with greater input on one aspect of remuneration, termination payments, has just been introduced in the Corporations Amendment (Improving Accountability of Termination Payments) Bill 2009.

CSA refers to the list of shareholder rights in relation to remuneration provided on page 14. CSA believes that the current regulatory arrangements allow shareholders to be adequately involved.

---

[23] Ann Byrne, 'Investing for the longer term — ensuring all risks are accounted for', *Keeping good companies*, Vol 61, No 4, p 205

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?

CSA opposes calls for a binding vote on the remuneration report

CSA notes that in November 2008 the Leader of the Opposition, Mr Malcolm Turnbull MP, in an address to the National Press Club recommended that 'The law should be changed so that the shareholders' resolution on the remuneration report, or at least that part relating to the chief executive, as well as directors, is binding. This would clearly place the remuneration of senior executives and directors directly in the hands of shareholders. It is their company, and nobody else's. Let the executives justify their pay to the shareholders and if the shareholders don't approve it, then so be it'.

There are numerous practical difficulties in making the vote on the remuneration report binding, including that:

- the remuneration report deals with events that have already occurred — it is not clear what a binding vote in respect of past events would mean
- if remuneration is removed from the board, there may be ambiguity as to who is accountable for the performance of executives — this would be a governance quagmire
- remuneration reports are complex, and the shareholder vote is binary
- the remuneration report covers a number of different aspects of remuneration including the chief executive, other senior executives and non-executive directors. There is no way to determine which particular aspect might have lead to a no vote or what remedial action would be required to address a no vote
- boards may find that they are unable to recruit and retain executives with the necessary skills and talent due to remuneration restraints, that is, they are not in a position to finalise a contract when recruiting
- directors have a fiduciary duty to act in the best interests of the company as a whole. Shareholders have no such fiduciary duty.

CSA strongly opposes a binding shareholder vote on the remuneration report, not only because it blurs the line between owners and managers, but also because we note that significant representatives of institutional or retail shareholders hold a similar view.

Shareholder opposition to binding vote

In March 2009, ACSI issued a press release that stated:[24]

> Shareholders do not want to run companies – this is the role of the CEO managed by their boards. Boards manage their CEO and executives in terms of attracting and motivating them through remuneration practice. Shareholders want boards to ensure remuneration practice incentivises executives for the long term. The current non binding vote on remuneration provides shareholders with the opportunity to engage with boards of companies on their long term strategies ... Shareholders do not have the expertise to develop policies that accommodate each individual company's strategy — they can advise the board as to their satisfaction with long term alignment. We do not require a binding vote on remuneration policy.
>
> We have and will use our binding vote on the election of directors — it is the board who are accountable for the development of remuneration policy — not shareholders — it is our job to provide a view on both incentive structures and quantum. The community has already expresses their view on both these issues. If a company ignores the views of shareholders - directors will be held accountable.

[24] Australian Council of Superannuation Investors, *Media Release — Binding Vote on Pay*, 3 March 2009

In February 2009, the ASA issued a press release that commented on shareholder dissatisfaction with excessive executive remuneration, but that did not call for a binding vote on the remuneration report. The ASA had a different proposition for strengthening the non-binding shareholder vote:[25]

> Shareholders want more from the advisory vote on the remuneration report, with over 90 per cent (91.4%) calling for the chair of the remuneration committee of any company receiving a majority vote against the remuneration report to automatically face re-election at the next AGM.

In a second press release issued in March 2009, the ASA stated that:[26]

> Directors are responsible for setting executive remuneration …. If they continue to fail shareholders then it is not appropriate for them to remain on the board. …If a company was a recipient of a shareholder backlash on executive pay last year, and directors have failed to remedy the situation, the ASA will hold those directors responsible and vote against their re-election at the Annual General Meeting.

An article quoted the ASA commenting on its opposition to the concept of a binding vote:[27]

> Is Turnbull's plan the answer? ... The Australian Shareholders' Association says it is a bad idea because it would mean shareholders crossed the line that prevents them from managing the companies they own. Corporate governance experts say it is a bad idea because, by definition, the votes would happen after the money had already been paid, meaning they would have to be implemented retrospectively.

Shareholder activist Stephen Mayne commented in his online bulletin:[28]

> Malcolm Turnbull surprised many people in Question Time today when he suggested non-binding votes on executive pay should be made binding. Unfortunately, this is an unworkable proposal as Malcolm should know. You can't make something as generic as a report into remuneration binding. What happens if it is defeated? Does the CEO give back his bonus? Are executive contracts deemed null and void?

CSA agrees that a binding vote on the remuneration report is unworkable. CSA does not support the introduction of a binding vote on the remuneration report.

CSA notes that the vote on non-executive director remuneration is already binding (s 202A). Listing Rule 10.17 requires that total director remuneration cannot be increased without shareholder approval. Non-executive directors do not receive bonuses — their remuneration is fixed.

Voting on the remuneration report by directors and executives who hold shares

There is a conflict of interest in directors and CEOs voting on their own remuneration policies. CSA believes that this disempowers shareholders.

---

[25] Australian Shareholders' Association, *Shareholders call for action on excessive executive pay*, 12 February 2009

[26] Australian Shareholders' Association, *ASA toughens stance on executive remuneration*, 23 March 2009

[27] Lenore Taylor, 'It doesn't pay to talk loud, forget the stick', *The Australian*, 29 November 2008

[28] Stephen Mayne, 'Malcolm Turnbull's executive pay plan', *Mayne Report*, November 2008

Strengthening the non-binding vote on the remuneration report
CSA notes that shareholders wish to see that directors are accountable for their stewardship of investors' money.

It has been suggested that one way to hold boards accountable where the majority of shareholders have rejected the remuneration report (an adverse vote of 50 per cent or more) would be for the members of the remuneration committee to stand for re-election at the subsequent AGM, regardless of the normal cycle of director re-election. It has been proposed that this would encourage all remuneration committee chairmen and members to engage with their investors on remuneration, as it puts pressure on directors that their positions are under threat if they do not attend to shareholder concerns.

Concerns have been expressed with this suggestion as it could impair the unitary role of the board. These concerns note that the role of the remuneration committee is to make recommendations to the board on remuneration. The remuneration report forms part of the directors' report which is signed in accordance with a resolution of the board.

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?

Voting rights
CSA notes that there are no barriers to institutional shareholders voting. Institutional shareholders are more engaged than ever before and most vote.

The exercise by institutional investors of the voting right attached to the shareholding represents the most visible tool available to them to exert influence over the governance practices of companies in which they invest. The IFSA Blue Book states that 'IFSA Standard No.13 — Proxy Voting requires fund managers to have a formal proxy voting policy, approved by the board, that sets out the principles and guidelines under which proxies are voted. The proxy voting policy must be made available to scheme members on request. The Standard provides that the fund manager should vote on all resolutions in respect of which it has discretion to vote and not merely material resolutions. Additionally, an aggregate summary of its Australian proxy voting record must be published at least annually within two months of the end of the financial year'.[29]

Another tool, as noted earlier, is to not invest or sell their shares. Any decision on this front is best represented through engagement with the boards of companies so that the boards can understand investor concerns.

Australian institutional investors generally hold positions in hundreds of listed Australian companies. Often they do not have the 'in-house' capability or resources to conduct independent research about each agenda item for each company's ballot at general meetings, including the AGM. Proxy advisory services undertake research and assessment and advise institutional investors on governance arrangements within companies. They evaluate the numerous resolutions proposed by companies, including the resolution on the remuneration report, and make recommendations to institutional investors on how to vote on these resolutions.

---

[29] Investment and Financial Services Association, *IFSA Guidance Note No. 2.00 Corporate Governance: A Guide for Fund Managers and Corporations*, May 2009, at 10.4 Guideline 3 – Voting on company resolutions, p 17.

Institutional investors take seriously their responsibility to vote their shares on resolutions put to members at general meeting and consider the governance of the entities in which they invest. Superannuation funds and fund managers are required to assess agenda items with care and caution, and exercise their votes in a manner consistent with their fiduciary duties. Even the best-resourced funds require quality, independent information gathered by proxy advisory services. Accessing quality, independent information in relation to a range of issues assists institutional investors to discharge their voting responsibilities. Such information, which includes recommendations on voting on proposals to be put to shareholders, may have a material effect on voting results.

Some companies have expressed concern that proxy advisory services ‘control’ the votes of their clients, the institutional investors. However, institutional investors have an obligation to make their own decisions and vote accordingly.

Yet proxy advisory services do wield influence and that influence should not be underestimated. The recommendations put forward by proxy advisory services will be attended to by those who commissioned the research. In some instances, investors may not exercise their discretion or may be reluctant to vote against the recommendations of proxy advisory services.

In 2008 CSA organised a Roundtable attended by institutional investors, proxy advisory services, company secretaries, retail investors, directors and other governance advisers to examine how to improve engagement between investors, proxy advisory services and companies. CSA published *Better communication between entities and proxy advisory services* containing recommendations for good practice that arose from the Roundtable and provided a copy of the publication to the chairman and company secretary of the top 200 ASX listed companies and all CSA members.

In order to assist institutional investors exercise their voting rights, the publication recommends that proxy advisory services should:

- contact issuers in advance of publication of their reports with respect to ambiguity or contentious issues in the issuers’ publicly available documents
- provide issuers with an explanation for negative recommendations
- correct factual errors in their reports to institutional clients immediately
- provide a copy of their report upon request to issuers, once it has been released to institutional investors, independently of a corporate subscription
- make their guidelines publicly available on their websites
- enter into a dialogue with issuers independently of a corporate subscription.

CSA recommends that institutional investors be encouraged to vote, but strongly opposes any regulation of this. CSA firmly believes that institutional shareholders should not be required to vote, or required to disclose how they vote on individual companies.

A decision to abstain from voting on a matter, which may result in no proxy form being lodged and no attendance at a meeting, may be in accord with an investor consideration or policy. Some institutional investors have decided not to vote on director elections, but to sell the stock if they do not agree with the board’s decisions.

CSA suggests that institutional shareholders may wish to consider developing policies on voting, and disclose those policies to their members.

Broader interests of shareholders
Companies used to be a community comprising a small number of investors with similar interests, known to the directors and who could have a large impact on outcomes by voting. There were considerably fewer opportunities in the media and analysts' research for shareholders to receive continuous and near real-time information on the performance of the company. However, investors now have many different financial and other interests in companies and are not necessarily long-term investors (they can be 24-hour investors). The concept of the community of shareholders known both to each other and the directors is no longer operative.

Shareholders today are a diverse group, dispersed geographically (including internationally) and, in many large companies, can number in the thousands, if not the millions. With dynamic and global investment strategies, shareholders may include an individual resident in Australia planning for his or her retirement, a large institution with billions of dollars under management, a foreign investor, a global hedge fund, and an investor with no interest in the company beyond a short-term trade. The traditional retail investor in Australian equities may represent a small proportion of the capital of a large ASX-listed company.

It is difficult therefore to speak of the broader interests of shareholders, given the diversity of investors and their different interests. Those interests are not always aligned.

Institutional investors and voting
The issues paper states that 'the dominant role of institutional investors in shareholder voting are said to be providing an insufficient check to align the interests of companies and shareholders'.

Since the introduction of a compulsory superannuation scheme 17 years ago in Australia, corporations have benefited from the liquidity supplied by institutional investors such as superannuation funds. One governance commentator notes that 'Domestic institutions alone today own around 40 per cent of ASX listed companies, and their share continues to grow'.[30]

CSA contends that it is appropriate that institutional investors have a dominant role in shareholder voting when they own the majority of the shares.

However, one aspect of remuneration that does need to be considered is how fund managers are rewarded. Generally, their incentives are misaligned both with the interests of the investors whose interests they are paid to serve as well as with long-term sustainable value-creation in companies. Many funds managers are rated and paid based on quarterly performance. As a result, there is an incentive to maximise quarterly value. Stock will be churned and traded on the basis of short-term speculation. The share is viewed as a commodity, not an investment.

As noted above, shareholders are a diverse group, and their interests are not always aligned. It is difficult for boards to redesign the structure of senior executive pay in order to ensure greater shareholder alignment if remuneration in the funds management industry is not also redesigned. While boards are exhibiting behavioural change in response to changed financial conditions, we are not aware of similar behavioural change occurring in the funds management industry.

---

[30] Erik Mather, 'Towards a new capitalism?', *Keeping good companies*, Vol 61, No 4, p 212

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?

Listing Rule 10.14

Shareholder groups have been calling for the reform of Listing Rule 10.14 to provide shareholder approval of the purchase of shares on-market for directors and senior executives.

CSA believes that no further shareholder approval should be required where directors choose or a company requires directors to take some part of their fees in shares purchased on-market.

On this basis, Listing Rule 10.14 should be redrafted to state more clearly that the only acquisitions of securities by directors under employee incentive schemes that require shareholder approval are those involving an issue of new shares (or, in the case of executive directors, an issue of options and/or performance rights that will ultimately result in the issue of new shares if performance hurdles are met), and not those involving the on-market purchase of existing shares.

A redrafting of Listing Rule 10.14 on the lines recommended would confirm that the underlying philosophy for a shareholder approval requirement is a combination of:

- protection of other shareholders whose shareholdings (as a percentage of issued capital) may be diluted by 'new' issues and
- protection of shareholders where directors may have a conflict of interest in approving such plans and share issues.

The purchase of shares on market does not dilute the shareholdings of existing shareholders.

Companies should continue to be required to address in their remuneration reports the particulars of their share plans, including the policy behind the adoption of the share plan and the relationship between the policy and the company's performance.

Shareholder engagement

AS noted earlier, shareholder involvement in decision making is restricted to key rights that shareholders can exercise in general meeting to elect directors and vote on the aggregate amount of non-executive director remuneration, as well as other rights such as to amend the constitution. Shareholder involvement in day-to-day decisions would paralyse the company.

However, shareholder engagement is central to good governance and, as noted earlier, one of the key tools to achieve successfully shareholder engagement has been the non-binding vote on the remuneration report.

CSA believes it is important to look at the overall interaction a company has with its shareholders when considering shareholder engagement. For example, results announcements, analysts' briefings, investor roadshows, 'investor days' (or shareholder briefings), the AGM and other forms of communication all form part of engaging with shareholders. There is a range of options available to companies to communicate with their shareholders and, to a lesser extent, for shareholders to communicate with the companies in which they invest.

CSA considers that shareholders are seeking satisfactory performance from the companies in which they invest and, to the extent it is linked to performance, good governance. Shareholder engagement is a means for shareholders to achieve this end, not an end in itself. On this basis, CSA believes that companies need to review their communication with shareholders and analyse which forms of communication work and why. Companies and shareholders alike need to understand and clearly articulate the objectives they are hoping to attain through enhanced shareholder engagement.

However, shareholder engagement and shareholder involvement are not synonymous. As noted earlier, CSA strongly believes that directors should have the responsibility to determine executive remuneration, as boards are best placed to take into account the financial and operational circumstances of the company, which may shift year to year, when assessing remuneration structures.

Directors are taking all decisions on behalf of shareholders, not just those relating to remuneration. If shareholders distrust directors' decision making on remuneration, a bigger question arises about the directors' decision-making capabilities across all decisions. The competence of boards to take other decisions, many of which are likely to have a greater impact on shareholder value than remuneration practices, is not under similar scrutiny. CSA does not believe remuneration decision making can be divorced from the vast range of other decisions taken by directors in the best interests of their companies. Shareholder involvement, in all such instances, is to exercise their right to remove the board.

Section 4: Aligning interests

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?

CSA contends that the interests of shareholders, the board, executives and the wider community are aligned for the vast majority of listed companies. Misalignment of interest is not the norm, although it may garner the most attention.

Termination payments

There have clearly been some exceptional cases of significant termination payments, where the justification for the amounts involved is questionable. These cases attracted widespread publicity and created an assumption that all termination payments were excessive or were 'rewards for failure'. These instances of abuse have already resulted in the government introducing the Corporations Amendment (Improving Accountability of Termination Payments) Bill 2009.

The implication of the debate on termination payments is that termination payments are unacceptable under all circumstances. However, termination payments may be consistent with good governance. However, academic research has indicated that termin`ation payments can be justified:[31]

> When considering the rationale behind the provision of termination payments to senior executives, the question that should be asked is: Why should an executive be rewarded at the moment his or her contribution to the company ceases to exist? The literature reveals four main arguments in support of such payments. First, termination payments can reward departing executives for long-term and/or outstanding service to the company.[32] Second, termination payments provide an incentive not to disclose corporate information to competitors or cause adverse publicity when leaving the company (whether through litigation or otherwise).[33] Third, termination payments can help a company attract talented executives, as well as serve as a safety net, encouraging executives to take more risks in the interests of shareholders. This is particularly the case where an executive is hired to turn around a failing company. Usually the best people for the job have a secure position elsewhere, and thus the promise of a payment on departure can help convince an executive that he or she will be adequately compensated for taking the risk, even if that risk ultimately does not pay off.[34] Fourth, if there is a possibility of a company merging or being taken over, termination payments ensure a measure of objectivity on the part of executives during negotiations. Executives may otherwise not act in the best interests of shareholders because they are more concerned about losing their jobs following the change in management that will occur if their company is taken over by another.[35]

---

[31] Geof Stapledon, 'Termination Benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27: 683, 2005. At the time of publication, Geof Stapledon was Managing Director, ISS Australia, a key governance and proxy advisory firm in Australia, and Professor of Law, University of Melbourne

[32] John Shields, Michael O'Donnell & John O'Brien, The Buck Stops Here: Private Sector Remuneration in Australia A Report Prepared for the Labour Council of New South Wales (2003) at 7; Philip Cochran & Steven Wartick, 'Golden Parachutes: A Closer Look' (1984) 26 *California Management Review* 111 at 120

[33] Dan Dalton, Catherine Daily & Idalene Kesner, 'Executive Severance Agreements: Benefit or Burglary' (1993) 7 *The Academy of Management Executive* 69; Cochran & Wartick, above

[34] Dalton, Daily & Kesner, above at 79

[35] Peter Scotese, 'Fold Up Those Golden Parachutes' (1985) 63 *Harvard Business Review* 168 at 170; David Maurer, 'Golden Parachutes: Executive Compensation or Executive Overreaching' (1984) 9 *J Corp L* 346 at 351

CSA believes these reasons need to be borne in mind when considering termination payments and their alignment with shareholder interest. CSA also notes that termination payments include payments made for retirement, resignation, redundancy and death more frequently than payments made for poor performance.

Modified corporate behaviour as a result of the non-binding shareholder vote on the remuneration report

As noted earlier, it has already been shown that corporate behaviour can be modified in response to investors engaging with boards and discussing matters of concern in relation to remuneration. The introduction of the non-binding shareholder vote in 2005 on the remuneration report has seen marked changes in the remuneration structures at companies where shareholders had concerns with remuneration plans. As mentioned, since 2005, only 25 listed entities have received a no vote of more than 20 per cent on the remuneration report.[36] There are approximately 1,800 listed companies in Australia, all of which need to disclose to shareholders on issues of remuneration. Of those, only three entities have twice received a no vote of more than 20 per cent, revealing that shareholder engagement and pressure has been successful in modifying board behaviour.

The most high-profile example of a modification in board behaviour was Telstra. In 2007, the board received a no vote of 66.18%, on the basis of insufficient performance hurdles or disclosure for the CEO's package. The board was widely condemned by shareholders, governance advisers and in the press for not changing its remuneration structures in response to this strong expression of dissatisfaction. Yet one year later, at the 2008 AGM, after serious engagement with investors on the matter, 95.49% shareholders voted in favour of the remuneration report. While there were some areas of the remuneration package offered to the CEO that continued to be debated in 2008, proxy advisory services recommended a vote in favour of the remuneration report, in recognition of the changes that the board had made overall in remuneration structures. An article at the time noted that:[37]

> 'Given the progress they've made over the last year we're recommending in favour of the report —- you've got to give credit where credit's due,' RiskMetrics Australia director Dean Paatsch said yesterday.

Employee share plans changes lead to misalignment

On 12 May, the Australian Government issued a press release indicating that new measures would be introduced to remove some tax concessions, and limit others, for employees who acquire shares and options under employee share schemes. The government's announcement resulted in the suspension or cancellation of many general employee share plans and removed the 'equity' remuneration component from the strategy of many 'cash poor' start-up companies. This has resulted in a misalignment of the interests of management and employees, as the latter are denied the opportunity to become shareholders. CSA comments on this in more detail on page 43 in this submission.

[36] *The Mayne Report*, January 30, 2009

[37] Fleur Leyden, 'Telstra heeds rings of ire', *Sun Herald*, 20 November 20, 2008

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?

CSA questions the assumption that the wider community has a direct role to play in relation to executive remuneration. The Productivity Commission's issues paper notes that corporate governance failures in companies can 'impact more widely on the community' and proceeds to offer the example that 'poorly structured remuneration packages have encouraged inappropriate risk taking within the finance sector [and] this can have effects on the operation of the financial system as a whole, with flow-on effects to the wider economy and community.

CSA points again to the reference from the government to APRA on whether executive remuneration in APRA-regulated financial institutions is structured to promote long-term sustainability and avoid perverse incentives and notes that APRA has already issued its draft revised prudential governance standards for public consultation. CSA reiterates that the issues that have arisen in the finance sector are not generally applicable to all companies or other industry sectors. It is inappropriate to make determinations in relation to companies outside the financial sector based on occurrences in that sector. As pointed out by the European Corporate Governance Forum on director remuneration:[38]

> the remuneration issues related to financial institutions should be distinguished from remuneration issues as general corporate governance issues. Both in terms of the relation between financial incentives and risk taking by the institution and in terms of the relation between executive remuneration and remuneration of employees of the institution, financial institutions have specific systemic characteristics that merit special treatment.

In companies outside the financial sector CSA strongly believes that it is for boards to determine the appropriate level of risk taking for the company they govern and for directors to be accountable to shareholders.

The Productivity Commission's issues paper also notes that 'More generally, if entrepreneurial activity is diverted to unproductive 'rent-seeking' behaviour as executives seek ways to maximise and camouflage their remuneration, this can affect not only the performance of a company, but also inhibit the productivity and growth prospects of the economy. Executive remuneration that is many multiples of average earnings may also impact on workers' productivity and make wage restraint more difficult to achieve in periods of economic downturn'.

Corporate governance recognises the broad objective of maximising shareholder value, while taking into account the reasonable expectations of other stakeholders with an interest in the company's affairs. This approach recognises that the relationship between business and society is an implicit social contract.

For example, a large corporation operating in multiple jurisdictions is concerned with the corporation's impact, both direct and indirect, on the economic resources of its stakeholders and on economic systems at the local, national, and global levels, including such matters as employee wages, financial arrangements with customers and suppliers, and taxes. Environmental impacts include the corporation's products and services; energy, material and water use; greenhouse gas and other emissions; effluents and waste generation; impacts on biodiversity; use of hazardous materials; recycling, pollution, waste reduction and other environmental programs; and the cost of non-compliance with environmental regulation.

---

[38] Statement of the European Corporate Governance Forum on Director Remuneration, 23 March 2009

Social indicators concern a corporation's impacts on the social systems within which it operates, which can include labour practices (for example, diversity, employee health and safety), human rights (for example, child labour, compliance issues), and broader social issues affecting consumers, communities, and other stakeholders (for example bribery and corruption, community relations).

However, a concern of this kind does not of itself provide the wider community with rights to dictate executive remuneration in companies. Issues of remuneration are a matter for shareholders and the board, that is, they are a matter for those with a financial stake in the company.

Directors have statutory duties to act in the best interests of the company. They do not have statutory duties to act in the interests of the wider community, although they need to have regard to the expectations of stakeholders, including the wider community, when making decisions. Companies must operate in communities. Boards cannot afford to ignore the wider community when taking decisions as the company's licence to operate can be jeopardised. Events at James Hardie have demonstrated this in recent years.

There will be circumstances where board decision making will result in a clear impact on the community. For example, a board can decide to close a regional operation that is making losses sufficient to threaten the future of the whole company, and this decision will clearly affect the local community. However, in such circumstances, the directors are acting in accordance with their statutory duties and they would be in breach of their duties if they did not make such a decision and accordingly put the company as a whole at threat.

As noted earlier, shareholders are a diverse group and their interests cannot be definitively described as unanimous. It is not feasible to say that all shareholders' interests are aligned. A shareholder who is on the register for 24 hours may not have the same interests as one who seeks to remain on the register over decades. Therefore, while some shareholders' interests are likely to align with what is deemed to be the interests of the wider community at various points, other shareholders' interests may not so align. (Of course, the question then arises as to who makes the judgment of what the community interest is as at any point in time, as this will also shift according to the identity and beliefs of the person making the judgment.)

In relation to executive remuneration, boards may include performance measures in executive performance plans in relation to matters such as occupational health and safety and the impact of the company on the environment, which matters could be said to have reference to the wider community. However, the board will include such measurements only where the board deems them to achieve the objectives of the company.

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?

As noted above, corporate governance recognises the broad objective of maximising shareholder value, while taking into account the reasonable expectations of other stakeholders with an interest in the company's affairs. This approach recognises that the relationship between business and society is an implicit social contract. However, this does not mean that a company has a relationship with the general public in the manner in which a government has a relationship with the community, comprised of citizens. Government exists to serve the interests of citizens. Corporations do not exist for this purpose.

As it stands, the law generally links a company's interests to those of its shareholders, and only derivatively with those of the community, consumers, employees and other stakeholders. The two recent inquiries conducted by CAMAC and the PJC on corporate social responsibility found that the current legal framework governing directors' duties accommodates directors having regard for the interests of stakeholders other than shareholders, as this is consistent with their fiduciary duty to exercise their powers in the best interests of the company.

As noted in the CAMAC report *The Social Responsibility of Corporations*:[39]

> Companies are subject to a range of Commonwealth, State and Territory laws of general application that are designed to protect various interest groups or public values, including environmental protection, occupational health and safety, workplace relations, competition, consumer protection, human rights (such as anti-discrimination) and anti-corruption statutes. Directors cannot ignore or subordinate these corporate obligations because of any notion either that the financial or other interests of shareholders are paramount or that compliance with these laws may reduce shareholder returns.

The power to manage a company's affairs derives from its shareholders, who together own the company. In the two reports, there was general agreement that changing the law to make directors' duties take into account broader community considerations could mean that directors become less accountable (they are stewards of other people's money and have fiduciary responsibilities to those investors), because their duties become generalised. The dilution of accountability would make it harder for shareholders and regulators to hold directors responsible for their decisions. For example, it would be a breach of their duties to disregard the interests of the shareholders in order to confer a benefit on one or more categories of stakeholders such as employees.

The CAMAC report found that:[40]

> The Committee acknowledges concerns expressed in some submissions about the possible undue focus of some companies on short-term performance and immediate returns to shareholders, to the neglect of longer-term planning and development, including in relation to the environmental and social impact of their operations. However, investors may differ as to the relative importance they place on the value of their investments over the shorter and longer term. The law ... gives directors and other managers considerable room for judgment in their assessment of what is called for in the interests of the company. They may legitimately choose longer-term over shorter-term considerations in particular situations. Directors therefore have it within their power to chart the course for the company and face the challenge, not always easy, of communicating that course and gaining market support for it. The Committee does not see this as an issue that can usefully or appropriately be resolved by legislation. How particular companies balance, or prioritise, short-term and longer-term considerations calls for commercial judgment. Practical measures that companies may adopt to achieve a suitable balance for their circumstances include tailoring executive remuneration to shorter-term or longer-term corporate objectives and strategies and communicating with shareholders and the market generally about these objectives and strategies.

---

[39] Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations: Report*, December 2006, p 95

[40] As above, pp 112-113

Notwithstanding this, CSA believes that companies should be encouraging decisions with a longer-term focus, which in remuneration would mean shifting the focus of incentives from short-term targets and outcomes toward longer-term outcomes. As noted earlier, similar shifts from a short-term to longer-term focus in the remuneration of fund managers would assist this.

It is also important to note that at present, in the current economic downturn, companies are not simply sacking workers, but are also looking at more creative ways of cutting costs, having regard to the need to retain an employee talent pool for when the economy recovers, and also on the basis of being responsible employers. In many large companies, executives are leading the way in terms of modelling different behaviours for different economic circumstances. At Wesfarmers, for example, the board has frozen salaries and directors' fees and cut annual bonuses. At ANZ, for example, executives are taking salary cuts. Bendigo and Adelaide Bank recently announced that the new CEO will not get a salary increase in the first year on taking up the new role and responsibilities. At AMP Capital, unpaid leave is being used as a strategy.

Notwithstanding all efforts on the part of companies to look for creative ways to cut costs, it is ultimately in the interests of the community for companies to survive. Sometimes, redundancies are the only solution available, and in such cases there should be appropriate compensation. Positions in companies are made redundant for a variety of reasons. A position could be made redundant because an industry is contracting through mergers and acquisitions, because a company is restructuring, or because of difficult economic circumstances such as is being experience at present. There are other legitimate reasons for dismissing workers. Employees could be dismissed for non-performance (for example, customers may have suffered), or a mismatch of skills with new technologies.

One final matter that relates to the questions posed in this section of the issues paper requires comment. The recent case of the remuneration extended to the CEO of Pacific Brands Ltd was discussed in the media in relation to the cost cutting initiated by her that saw the majority of the company's Australian employees made redundant as the company restructured and moved its operations offshore. Most media articles misreported the CEO remuneration as an increase in remuneration for no reason other than greed, when in fact the CEO had been promoted to the position from another less senior position in the company. It is appropriate that a person should receive an increase in remuneration when promoted.

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

The performance measures put in place by companies will be unique to the circumstance of each company. In one company the focus in a particular period may be on retention, whereas in other companies, or in the same company at a different period, the focus will be on driving short-term performance. Matters to take into consideration include industry, strategy and current positioning in the growth cycle (for example, it needs to be considered whether the company is a start-up or an established one, or whether it is entering new markets). A company needs to have the freedom to utilise those measures that best achieve the objectives of the company.

A variety of performance measures are currently used, including:

- relative total shareholder return (TSR), which measures the value of a company's change in share price and takes into consideration the value of all dividends paid by the company and reinvested in shares
- earnings per share (EPS)
- various shareholder-added value measures
- as noted earlier, measures related to occupational health and safety and the impact of the company on the environment (as appropriate)

CSA believes that no performance measure should be mandated or disallowed, as the board requires the discretion to use them according to the circumstances of the company. It is important that this accountability be left with the board as it is an essential element of running the business and a tool in risk management.

However, CSA suggests that improvements to aligning performance measurements and the interests of shareholders could be assisted by:

- staggering the receipt of incentive payments/shares over longer periods
- weighting measures such as relative TSR with a range of other measures of specific relevance to the company (for example, production and safety performance measurements would be appropriate for mining companies)
- reducing the size of the 'at risk' component. CSA notes that if the size of the 'at risk' component of remuneration was decreased, remuneration for the CEO and other senior executives is likely to change less from year to year, which could ameliorate shareholder concern that remuneration is misaligned with their interests.

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

CSA recommends that it is good practice for boards to:

- clearly articulate the board's remuneration philosophy and the process by which it determines executive remuneration
- engage with shareholders and clearly explain the company's remuneration framework, the rationale for the framework and the outcomes it produces
- structure incentives to drive performance that rewards shareholders over the long term
- take accountability for their remuneration decisions, including in response to feedback from shareholders through votes on the remuneration report
- ensure that there is a clearly agreed contractual right to terminate the CEO and any senior executives appointed by the board
- ensure that the contractual rights for CEOs and executive directors are fully disclosed to shareholders
- ensure that all vesting rights attaching to equity incentives are publicly disclosed at the time the CEO enters into a contract
- ensure, where an executive departs prior to a vesting date, that long-term incentives are limited on a pro-rata basis to the period served and that any entitlements are measured as far as possible on the original performance targets
- ensure that board discretion on remuneration is clarified in performance plans and that executives are aware that it exists and that the board can exercise it
- not shirk their responsibilities to dismiss poor performers without additional payments.

CSA also refers to our earlier recommendation that it is best practice for boards to:

- engage their own remuneration adviser to review the remuneration package for senior executives put forward by management and remuneration consultants appointed by management
- ensure their remuneration adviser is appointed by and solely accountable to the remuneration committee
- disclose in the annual report the names of the remuneration consultants, whether they were appointed by the remuneration committee and the types of services they provide to the company.

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

CSA points to the fact that in the United States, in most instances, the chairman and chief executive officer are one and the same person. This can result in a fundamental conflict of interest, with the executive potentially having an inappropriate degree of influence on the setting of his or her remuneration. CSA notes that this is rarely the case in Australia, where the principle of independence is central to the governance framework.

The ASX Corporate Governance Council's guidelines, against which all listed companies must report, states in Recommendation 2.3 that 'The roles of chair and chief executive officer should not be exercised by the same individual'.[41]

The Council's guidelines also state in Recommendation 2.1 that 'A majority of the board should be independent directors'.[42] The guidelines note in Box 2.1 the relationships affecting independent status, clarifying that they are adapted from the definition of independence given by *Corporate Governance: A Guide for Fund Managers and Corporations — Blue Book*, issued by the Investment and Financial Services Association in 2004.

The relationships set out in the Council's guidelines are:

> When determining the independent status of a director the board should consider whether the director:
> 1. is a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company
> 2. is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board
> 3. has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
> 4. is a material supplier or customer of the company or other group member, or an office of or otherwise associated directly or indirectly with a material supplier or customer
> 5. has a material contractual relationship with the company or another group member other than as director.

Principle 8 calls for the establishment of a remuneration committee.

CSA notes that the governance framework in existence in Australia is intended to ameliorate any undue influence that a CEO may try to exert.

On the matter of the governance framework established by the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, it is important to remember that this derives from the consensus of a diverse range of stakeholders. The issues paper states that 'The ASX recommends against directors receiving options or bonus payments, or retirement benefits other than superannuation'. However, this guidance (it is not a formal recommendation) is issued by the ASX Corporate Governance Council in Principle 8 of its guidelines. It is not a directive of the ASX.

---

[41] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, Principle 2, p 17

[42] As above, p 16

It is important to differentiate between the ASX, which is a commercial entity with a markets supervision capacity enforceable through the contract between the exchange and the company (the Listing Rules) and the ASX Corporate Governance Council, which is an independent body.

The Council 'brings together 21 business, investment and shareholder groups. Its ongoing mission is to ensure that the principles-based framework it developed for corporate governance continues to be a practical guide for listed companies, their investors and the wider Australian community. The Council's diverse range of voices is one of its strengths. Its striving for consensus is consistent with maintaining balance in regulatory and reporting affairs'.[43]

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?

The forms of remuneration will vary from company to company and from year to year.

As noted earlier, CSA believes that improvements could be made to aligning performance measurements and the interests of shareholders by:

- staggering the receipt of incentive payments/shares over longer periods
- weighting measures such as relative TSR with a range of other measures of specific relevance to the company (for example, production and safety performance measurements would be appropriate for mining companies)
- reducing the size of the 'at risk' component. CSA notes that if the size of the 'at risk' component of remuneration was decreased, remuneration for the CEO and other senior executives is likely to change less from year to year, which could ameliorate shareholder concern that remuneration is misaligned with their interests.

CSA suggests that it could also be useful to have elements of the STI bonus delivered in deferred shares over some years to promote a longer-term alignment of interests.

CSA also reiterates that remuneration in the fund management industry needs to shift to a longer-term focus to ensure alignment of interests.

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?

Tax laws may need to change to ensure that, where an executive departs prior to a vesting date, long-term incentives are limited on a pro-rata basis to the period served and that any entitlement is measured on performance at the original vesting date (that is, after departure).

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?

Prudentially-regulated financial institutions act on behalf of specific groups — depositors, policyholders and superannuation fund members — who are generally not well placed themselves to assess the soundness of financial institutions on which they rely for their financial security. As such, the prudential regulator is interested in ensuring that financial institutions can survive adversity in any reasonably likely form. On this basis is it appropriate that there be

[43] As above, p 2

separate treatment of financial institutions, and APRA has revised its prudential governance standards linking regulated financial institutions' capital adequacy requirements to executive remuneration.

As noted earlier, there will be interest in the APRA's revised prudential governance standards but it cannot be assumed that their requirements are applicable to all companies or other industry sectors.

CSA notes that there is an argument that companies of national interest (for example, defence contractors) could also potentially be subjected to separate treatment.

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:

1 Should the shareholder votes on remuneration reports be (more) binding?
CSA strongly opposes a binding shareholder vote on the remuneration report, not only because it blurs the line between owners and managers, but also because we note that significant representatives of institutional or retail shareholders hold a similar view.

CSA notes that the vote on non-executive director remuneration is already binding (s 202A). Listing Rule 10.17 requires that total director remuneration cannot be increased without shareholder approval. Non-executive directors do not receive bonuses — their remuneration is fixed.

Please refer to our more detailed comments on this issue on pages 25—26.

2 Are the current approval processes for equity-based remuneration appropriate?
Yes. As noted, the issue of whether shareholders' interests will be diluted are already dealt with in the Listing Rules. Directors' duties to act in the best interests of the company and for a proper purpose also regulate these processes.

3 What effect does hedging have on aligning interests, and should this practice be permitted?
The ASX Corporate Governance Council's guidelines for executive remuneration packages already provide guidance that the terms of equity-based remuneration schemes 'should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes'.[44]

CSA supports the guidelines, which recognise that the hedging of unvested share rights detracts from an alignment of interest.

However, CSA believes that, once the shares have been issued, the executive should be free to hedge them if they so choose, as other shareholders are so free, provided it does not breach insider trading laws, or company share trading policies.

CSA recommends that any hedging of shares undertaken by directors should be discloseable.

---

[44] ASX Corporate Governance Council, Box 8.1: Guidelines for executive remuneration packages, *Corporate Governance Principles and Recommendations*, 2nd edition, 2007, p 36

4 Is the current regulation of non-recourse loans appropriate?

The Department of Treasury issued a consultation paper on non-recourse loans to executives in 2008. CSA lodged a submission at that time.

CSA's position remains unchanged from when we lodged our submission in May 2008. The provision of non-recourse loans to executives is not unregulated at present and **CSA recommends** that no further regulation is required.

The current regulatory framework requires disclosure in the annual report of non-recourse loans used as part of remuneration packages for executives, who are 'key management personnel' or the top five most highly remunerated executives; and to the extent that the disclosure is material requires immediate disclosure under ASX Listing Rule 3.1 also:

- requires shareholder approval where companies provide executives with financial assistance to purchase shares (s 260A (1)), and in the case of an executive director, confer a financial benefit on a related party (unless an exception applies)
- requires shareholder approval under the ASX Listing Rules of the issue of shares exceeding 15 per cent of capital (and many companies adopt the practice of obtaining shareholder approval under an exemption to this requirement on a three-year basis for issues under share plans to executives and employees)
- permits a reasonable balance between shareholder protection and providing the board with the flexibility to make a commercial decision with regard to the company's circumstances.

Non-recourse loans are not widely used or abused and where utilised are transparent and required to be reported to shareholders via the remuneration report.

If a loan plan is regarded as the most appropriate plan in the company's circumstances there are various ways in which it might be structured. Some companies have introduced performance hurdles in order for the loan repayments to be made through the application of dividends. The other point to bear in mind is that, while described as non-recourse, technically the loans are limited recourse, as there is recourse to the underlying shares.

5 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?

CSA believes that it is inevitable that conflicts of interest will arise in the arrangements by which remuneration consultants advise on director and executive remuneration. Remuneration consultants may provide services in addition to those attached to remuneration advice and may have prior relationships with senior executives or directors.

CSA refers to our earlier recommendation that it is best practice for boards to:

- engage their own remuneration adviser to review the remuneration package for senior executives put forward by management and remuneration consultants appointed by management
- ensure their remuneration adviser is appointed by and solely accountable to the remuneration committee
- disclose in the annual report the names of the remuneration consultants, whether they were appointed by the remuneration committee and the types of services they provide to the company.

6 Should government have a greater role in regulating remuneration?
CSA does not believe that regulators should second-guess commercial decisions designed to attract and retain executive staff.

Boards need to consider what is appropriate in terms of performance requirements when structuring executive remuneration. Over time, what is appropriate may change and the views of shareholders and governance organisations also change. These discussions are best left to shareholders and boards.

CSA opposes the government having a greater role in regulating remuneration.

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?

CSA believes that aligning the interests of boards and executives with those of shareholders is a matter best left to boards — directors are accountable. The wider community does not have a direct role to play.

An example of unintended consequences that can arise when the government seeks to limit or more closely regulate remuneration in Australia is the current outcry over its planned changes to how employee share schemes are taxed. On 12 May, the Australian Government issued a press release indicating that new measures would be introduced to remove some tax concessions, and limit others, for employees who acquire shares and options under employee share schemes. The press release indicates that tax deferral will no longer be available for employees acquiring shares and options under an employee share scheme. Rather, employees will be assessed upfront. This is irrespective of whether the shares or options are 'qualifying' shares or rights.

Under the government's plan, employees earning more than $60,000 would pay tax on shares the year they are purchased, even if the employee does not formally own the shares for several years — in other words, if they are subject to a vesting period. Previously, tax could be deferred until the employee gained formal control of the shares. The result of the planned changes is that employees could pay tax on shares they never receive.

The government noted that the planned reform was intended to crack down on tax breaks for higher income earners. Employee share schemes were introduced to attract, retain and motivate human resources in a company by giving employees a direct link to the fortunes of a company, thus aligning the interests of employees and boards. They provide employees, as shareholders, to participate in corporate governance debates and shareholder debates at AGMs.

The most recent statistics regarding employee ownership in Australia[45] show that 57 per cent of listed companies have a broad-based plan (or plans) and the most common plan was to take advantage of the $1,000 tax exemption.

---

[45] I Landau, R Mitchell, A O'Connell, I Ramsay and S Marshall, *Broad-Based Employee Share Ownership in Australian Listed Companies: Survey Report*, Melbourne Law School, The University of Melbourne, April 2009

As noted in The Australian:[46]

> There are about one million participants in employee share schemes in Australia, most of them middle- to lower-paid employees … Meanwhile, there is a very small group of senior executives, reportedly about 2,000, who for most of a decade have been exploiting their right to pay tax upfront on sophisticated performance share schemes that reportedly deprive the Treasury of as much as $100 million in tax in any given year. It appears that the government's entirely laudable intention to crack down on the prepayment rort by a very small group of highly paid executives has accidentally rendered uneconomic the employee share schemes that have existed in Australia since legislation first encouraged them in 1995.

The government's announcement resulted in the suspension or cancelation of many general employee share plans and removed the 'equity' remuneration component from the strategy of many 'cash poor' start-up companies. This has resulted in a misalignment of the interests of management and employees, as the latter are denied the opportunity to become shareholders.

Clearly, government regulation to 'fix' the problem of a small number of executives exploiting the system has created the unintended consequence of fundamentally misaligning the interests of employees and companies. CSA believes that this current example should signal that caution should be exercised by any attempt to limit or regulate more closely executive remuneration in Australia.

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

Europe

In order to enhance corporate governance in the European Union (EU), the European Commission established the European Corporate Governance Forum, which encourages the coordination and convergence of national codes. It comprises representatives from member states, European regulators, issuers and investors, other market participants and academics.

In March 2009 the Forum issued a Statement on executive remuneration that made recommendations as follows:

- Disclosure of the remuneration policy of listed companies and of the individual remuneration of directors (executive and non-executive) and any material change to it should be mandatory for all listed companies in the EU. The disclosure should contain sufficient detail to enable shareholders fully to understand the components of directors' remuneration as well as progress towards the achievement of previously granted awards and should include details on pension entitlements and increases thereof and perquisites and other benefits in kind. Currently only about 60 per cent of member states require disclosure of the remuneration policy and about two thirds of member states require disclosure of individual director pay. (*Note: Australia has required the disclosure of the remuneration policies of listed companies since 2003 when the ASX Corporate Governance Council's guidelines were first introduced. The disclosure of the individual pay of executive and non-executive directors has been required in the remuneration report since the CLERP 9 amendments to the Corporations Act were introduced in 2004.*)

[46] Andrew Main, 'The rort stuff hits share plans', *The Weekend Australian*, 16 May 2009

- An appropriate process for setting executive director remuneration requires that executive directors have no involvement whatsoever in setting executive director remuneration. Instead, this should be left to non-executive directors and to shareholders. Where shareholders do not determine individual director pay, such pay should be determined by non-executive directors within the framework of a remuneration policy. Non-executive directors involved in determining executive director pay should be independent of the company and its executive directors. Shareholders should be able to vote on the remuneration policy and any material change to it, whether in an advisory or binding capacity. Where shareholders do not determine individual director pay, schemes that grant shares or rights to acquire shares to directors or that remunerate directors on the basis of share price movements should be approved by shareholders. Remuneration consultants who advise on director pay should be independent of the company, its executive directors and other senior management and should only advise the non-executive directors and be designated by them. (*Note: the concept of independence has been enshrined in the ASX Corporate Governance Council guidelines for five years; shareholders have had a non-binding vote on the remuneration report since 2004; the Corporations Act and the Listing Rules require shareholder approval of schemes that grant shares or rights to acquire shares to directors and executives. Australia does not require remuneration consultants to be independent of the company*.)
- The substance of director remuneration should not be regulated in a mandatory way at EU level. It is for companies and their shareholders to determine what pay structure and levels are appropriate for their directors in light of their particular circumstances and different practices and traditions in member states are to be respected. The Forum set out key elements of best practice, including guidance that severance pay for executive directors should be restricted to two years of annual remuneration and should not be paid if the termination is for poor performance. (*Note: In May 2009, the Australian Government released draft of its new laws regulating executive termination payments. Under these new laws, termination benefits for directors and certain senior executive employees exceeding one year's average base salary will require shareholder approval.)*

The Recommendations in the Statement are not mandatory. The Forum recommends that these practices should be included in a code of corporate governance that listed companies are required to apply (that is, comply or explain).

United Kingdom

In the United Kingdom, s 439 of the Companies Act 2006 mandates a vote on director pay at the AGM. Directors are expected to have disclosed their remuneration package in a remuneration report (s 420). The shareholder vote on the remuneration report has been required for all listed firms since 2002 and is advisory. Most remuneration reports have received more than 90 per cent of votes cast in favour of the remuneration report. Only a few listed companies received such a substantial no vote (that is, above 50 per cent) that it could be said to be 'voted down': GlaxoSmithKline was the first in 2003 and then it was not until this year, as shareholders struggled to deal with the changed market conditions, that Bellway, the Royal Bank of Scotland and Royal Dutch Shell received substantial against votes.

Bellway plc's board issued the following statement after the AGM:[47]

> The board has noted shareholders' views on the report of the board on directors' remuneration and believes it was wrong in not consulting with major shareholders earlier. It therefore proposes to review future policy on this matter, in consultation with them, in the coming months.

Many companies have used the regulatory framework as an opportunity to engage with institutional shareholders and to demonstrate how remuneration policies fit within broader and changing company strategies. As a consequence of improved dialogue with shareholders, some are able to achieve 'bespoke' remuneration arrangements that fit their specific outlook and circumstances.

United States

The Securities Exchange Commission's Rules on Executive Compensation Disclosure require clarity and presentation of:

- director compensation table
- value of equity compensation
- directors' share ownership
- non-executive officer compensation.

As part of the federal stimulus package, more than 400 financial institutions will be required to hold non-binding shareholder votes in 2009 approving or rejecting executive compensation.

Shareholders at many public companies are also voting whether to permit shareholders to vote on non-binding resolutions on executive pay.

[47] Robert Goddard, 'UK: Bellway shareholders reject remuneration report', *Corporate law and governance*, 19 January 2009

29 May 2009

Manager
Corporate Reporting and Accountability Unit
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: terminationbenefits@treasury.gov.au

Dear Minister Sherry

Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

Chartered Secretaries Australia (CSA) is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. Our members comprise company secretaries and those with governance responsibilities in listed, unlisted, private and government-owned corporations.

CSA members agree with the introduction of a limit in relation to termination payments offered as 'golden handshakes'. When termination payments are granted during or following a period of poor company performance, shareholders can experience considerable disquiet at what is perceived as 'reward for failure'. However, although not attracting publicity, the majority of termination payments are not made in a context of poor company performance, and, therefore, CSA believes the legislation will need to carefully balance the legitimate interests of shareholders and executives. Good governance requires a practical and workable outcome.

Key recommendations

Our key recommendations are:

- The definition of 'termination benefit' should exclude those ordinary course payments that apply to the length of service generally. 'Termination benefits' should only include any amounts that differ from what would be due to a person if they resign or retire in the ordinary course.
- When calculating one year's fixed salary, fixed salary sacrificed into superannuation (including accumulation funds), shares or a pension fund in another jurisdiction should be included within the definition of 'base salary' for the purposes of calculating the maximum permissible termination payment, and superannuation account balances should be expressly excluded from the calculation of a termination benefit, subject to any necessary anti-avoidance provisions to protect against abuse.

CHARTERED SECRETARIES AUSTRALIA LIMITED ABN 49 008 615 950
LEVEL 10, 5 HUNTER STREET, SYDNEY NSW 2000, GPO BOX 1594, SYDNEY NSW 2001 **TEL** +61 2 9223 5744 **FAX** +61 2 9232 7174 **EMAIL** info@CSAust.com
www.CSAust.com

- Subject to a company's redundancy policy being of wide-ranging application across the company and disclosed, in the case of genuine redundancy, the key management personnel and the five most highly remunerated executives should be entitled to the same benefits that are available to employees generally under the terms of that policy and the payment should not require approval as a 'termination benefit', although it should be taken into account in considering whether any additional termination payments over and above those under the policy require approval.
- The legislation should define the persons to whom it applies as the key management personnel and the five most highly remunerated executives in the previous accounting year (that is, those persons disclosed in the remuneration report) and not extend to persons who are directors of non-listed companies and subsidiaries or persons who have at any time in the previous three years held a 'managerial or executive office' in a company or a related body corporate (unless they are disclosed as key management personnel or the five most highly remunerated executives).
- A practical and workable manner to obtain shareholder approval for termination payments to departing executives is to permit a company to submit a termination policy to shareholders for approval, and only require specific shareholder approval for payments outside the approved policy.

Knowledge of issues from the independent perspective of the company secretary

In public listed companies, responsibility for supporting engagement with shareholders on remuneration issues, monitoring changes in governance policies and issues of concern to shareholders in relation to remuneration and preparing the remuneration report for issue to shareholders frequently sits with the company secretary. The company secretary does not, however, make decisions concerning the levels or structure of executive remuneration: this rests with the board and its remuneration committee.

The company secretary drives and advises on best practice in governance; champions the compliance framework to safeguard the integrity of the organisation; promotes and is the sounding board on standards of ethical and corporate behaviour; and bridges the interests of the board or governing body, management and stakeholders.

Independent research has noted that:

> In order for the Remuneration Committee and Chairman to play an independent leadership role our research found that the role of the Company Secretariat was central to the successful outcome of the process, particularly where a major change in policy was taking place. Leading practice is for the Company Secretary to coordinate any necessary support to the Remuneration Committee and its Chairman. This resource is independent of the management HR systems (for example a senior independent adviser to the Committee), and can be supported by relevant expert third parties.[1]

Our members are uniquely positioned to provide independent, expert commentary on the governance and implementation issues arising from the proposed law reform of termination payments, including reporting to shareholders on this issue. Our comments in this submission are intended to assist the government to ensure that the legislation can be practically implemented to achieve the policy outcomes sought.

[1] Institutional Design, *Leading Practice in UK and Australian Remuneration Setting Process*, October 2008

Termination payments may be consistent with good governance

It is important to recognise that termination payments can and do serve a company's interests in many cases. Academic research has indicated that termination payments can be justified[2]:

> When considering the rationale behind the provision of termination payments to senior executives, the question that should be asked is: Why should an executive be rewarded at the moment his or her contribution to the company ceases to exist? The literature reveals four main arguments in support of such payments. First, termination payments can reward departing executives for long-term and/or outstanding service to the company.[3] Second, termination payments provide an incentive not to disclose corporate information to competitors or cause adverse publicity when leaving the company (whether through litigation or otherwise).[4] Third, termination payments can help a company attract talented executives, as well as serve as a safety net, encouraging executives to take more risks in the interests of shareholders. This is particularly the case where an executive is hired to turn around a failing company. Usually the best people for the job have a secure position elsewhere, and thus the promise of a payment on departure can help convince an executive that he or she will be adequately compensated for taking the risk, even if that risk ultimately does not pay off.[5] Fourth, if there is a possibility of a company merging or being taken over, termination payments ensure a measure of objectivity on the part of executives during negotiations. Executives may otherwise not act in the best interests of shareholders because they are more concerned about losing their jobs following the change in management that will occur if their company is taken over by another.[6]

CSA believes that these reasons need to be borne in mind when drafting the legislation, as it cannot be assumed that all termination payments are 'rewards for failure'. CSA believes that the legislation should carefully target 'rewards for failure' and on closing loopholes that provide opportunities for abuse, and avoid unnecessarily restricting genuine payments for retirement, resignation and death.

Our comments below are based on the key principles which we believe the proposed law reform is seeking to achieve:

- accommodation of the wide variety of circumstances leading to a termination payment
- the minimisation of loopholes
- boards being held accountable to an appropriate outcome
- shareholder and community expectations being met.

---

[2] Geof Stapledon, 'Termination Benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27: 683, 2005. At the time of publication, Geof Stapledon was Managing Director, ISS Australia, a key governance and proxy advisory firm in Australia, and Professor of Law, University of Melbourne

[3] John Shields, Michael O'Donnell & John O'Brien, The Buck Stops Here: Private Sector Remuneration in Australia A Report Prepared for the Labour Council of New South Wales (2003) at 7; Philip Cochran & Steven Wartick, 'Golden Parachutes: A Closer Look' (1984) 26 *California Management Review* 111 at 120

[4] Dan Dalton, Catherine Daily & Idalene Kesner, 'Executive Severance Agreements: Benefit or Burglary' (1993) 7 *The Academy of Management Executive* 69; Cochran & Wartick, above

[5] Dalton, Daily & Kesner, above at 79

[6] Peter Scotese, 'Fold Up Those Golden Parachutes' (1985) 63 *Harvard Business Review* 168 at 170; David Maurer, 'Golden Parachutes: Executive Compensation or Executive Overreaching' (1984) 9 *J Corp L* 346 at 351

Definition of 'termination benefit'

CSA notes that the government has drafted the legislation to broaden the definition of 'termination benefit' to catch all types of payment made at termination and all circumstances.

Wide variety of circumstances leading to a termination payment

There is a wide variety of circumstances that may lead to a termination payment. CSA is concerned that the current drafting of the Bill may inadvertently extend to commonly accepted bona fide payments made for:

- retirement (for example, accrued superannuation entitlements)
- resignation (for example, accrued annual leave entitlements)
- redundancy (for example, redundancy payments as per a company policy)
- death (for example, a death benefit payable by the superannuation fund to the person's estate).

Termination benefits should exclude ordinary course entitlements

CSA strongly believes that it is not appropriate to include in the calculation of 'termination benefit' those ordinary course entitlements that accrue according to length of service and that would apply broadly to employees within a company. For example, if a senior executive is made redundant after working for a company for 20 years and has accrued annual and long service leave, that executive is entitled to a redundancy payment together with the payout of that accrued leave and the company should not be required to seek shareholder approval for a payment which other employees receive as a matter of course.

CSA strongly recommends that any definition of 'termination benefit' should exclude those matters that apply to the length of service generally, such as:

- accrued annual leave
- accrued long service leave
- sick leave (to the extent that it can be cashed out)
- bona fide redundancy payments made in accordance with a policy applicable to all employees of the company
- short-term incentive (STI) or long-term incentive (LTI) payments (on a pro-rata basis) that have been earned during the period of employment but that become payable early as a result of termination of employment (a deferred bonus is already excluded in the draft regulations accompanying the draft bill)
- superannuation (including accumulation funds) or pension account balances already accrued
- the statutory superannuation contribution (which is already excluded in the draft regulations accompanying the draft bill).

These are accrued entitlements of the individual and should not be bundled together with 'rewards for failure'.

We note that s 200H states that 'Subsection 200B(1) does not apply to a benefit given by a person if failure to give the benefit would constitute a contravention of a law in force in Australia or elsewhere (otherwise than because of breach of contract or breach of trust)'. This could be construed as ordinary course entitlements not being threatened by the Bill, as failure to give the payment would constitute a contravention of a law in force.

However, it is unclear if the legislation can be read in this way.

On this basis, CSA suggests that the draft legislation requires clarification to ensure that ordinary course entitlements are excluded.

CSA recommends that the definition of 'termination benefit' should:

- exclude those matters that apply to the length of service generally
- only include any amounts that differ from what would be due to a person if they resign or retire in the ordinary course. This would capture payments in lieu of notice and most ex-gratia payments.

Superannuation

CSA notes that the statutory superannuation contribution is already excluded from the definition of a 'termination benefit' in the draft legislation. CSA believes that *all* superannuation should be excluded from the definition of 'termination benefit', subject to any necessary anti-avoidance provisions to protect against abuse. Our reasons for this are that:

- it should be a matter for an individual to decide how they choose to take their salary; that is, they should have the right to choose to take it as cash, shares or salary sacrifice into superannuation where facilitated by the company
- voluntary contributions may have been made over many years
- such contributions were paid as salary in the period prior to termination
- superannuation contributions sacrificed from salary are the property of the employee.

For example, an individual earning $200,000 per annum may sacrifice $50,000 into superannuation each year. They work for the company for five years. When terminated, their salary should be calculated as $200,000, as this was the fixed salary attached to the position. The $50,000 sacrificed per annum into superannuation should not be counted for the purposes of calculating the termination benefit, but should be counted for the purposes of calculating salary, as should the statutory superannuation contribution attached to that salary. Despite how the Australian Tax Office treats such monies, such amounts are available as salary and should be treated as part of 'base salary' for the purposes of calculating the maximum permissible termination payment.

The $250,000 that the individual has accrued in superannuation via salary sacrifice should be expressly excluded from the definition of termination benefit. It operates in such circumstances as a bank account — that money is the property of the individual.

CSA supports the draft legislation's exclusion of any defined benefit plan that was in place prior to the proposed legislation being enacted from the definition of termination benefit. The amount paid on exit is attributable to a formula that was, frequently, set in place many years ago. This is consistent with CSA's concern that it would be unfair to discriminate against long-serving employees.

Finally, CSA also notes that there are key management personnel who are employed by Australian companies but who work overseas and whose conditions relate to the jurisdiction in which they work. BHP Billiton and Rio Tinto are two examples of such companies. For example, the chief executive of Rio Tinto is based in London and has pension entitlements that are disclosed in the remuneration report. At present, the draft legislation does not recognise monies accumulated in such pension funds as salary, on the basis that such a fund is not 'superannuation under the laws of the Commonwealth'. CSA believes that the equivalent of superannuation funds offshore should receive the same treatment as superannuation.

CSA recommends that, when calculating one year's fixed salary, fixed salary sacrificed into superannuation (including an accumulation fund), shares, or a pension fund in another jurisdiction should be included within the definition of 'base salary' for the purposes of calculating the maximum permissible termination payment, and superannuation account balances should be expressly excluded from the calculation of a termination benefit, subject to any necessary anti-avoidance provisions to protect against abuse (that is, to protect against hiding a large termination payment in superannuation).

The difficulties of requiring shareholder approval of bona fide redundancy payments

Positions in companies are made redundant for a variety of reasons. Redundancy occurs at all levels and is often subject to a company's redundancy policy. A senior executive position could be made redundant because an industry is consolidating through mergers and acquisitions, because a company is restructuring, or because of difficult economic circumstances facing an individual company. Genuine redundancy is not about poor performance. It relates to the restructuring of the company in response to an adverse change in the circumstances of that entity.

CSA believes that in circumstances of genuine redundancy it is widely considered to be appropriate to make a termination payment. Such a payment would often be minimal in circumstances of a short-term appointment. However, a long-serving employee, possibly promoted during that tenure for good performance, may be entitled to a significant payment.

Where company policies apply to employees generally, it would be inappropriate to discriminate against long-serving senior executives who are made redundant. For example, a person with 25 years' service may have a six-month notice period plus a payment based on a broad company policy reflecting long service with the company (say, two weeks per year totalling 50 weeks). Under the terms of the draft legislation, a long-serving executive may not be able to be paid a redundancy payment without shareholder approval.

Redundancy payments in such instances are not unreasonable payments, and should include those long-term and short-term incentive payments (on a pro-rata basis) already earned if they amount to more than one year's base salary without being contingent on approval by shareholders.

CSA recommends that, subject to a company's redundancy policy being:

- of wide-ranging application across the company (that is, it extends beyond the key management personnel), and
- disclosed,

in the case of genuine redundancy, the key management personnel and the five most highly remunerated executives should be entitled to the same benefits that are available to employees generally under the terms of that policy and the payment should not require approval as a 'termination benefit', although it should be taken into account in considering whether any additional termination payments over and above those under the policy require approval.

CSA notes that Taxation Ruling TR 2009/2 provides guidance as to when a payment made to a person whose employment is terminated qualifies for treatment as a genuine redundancy payment under section 83-175 of the *Income Tax Assessment Act 1997* (Cth).

Extension of application of legislation beyond those disclosed in the remuneration report

Extending the present laws so that they apply to persons holding a 'managerial or executive office' with a company means that the legislation will apply to:

- for listed companies, those persons whose details were included in the directors' report (that is, the key management personnel and the five most highly remunerated officers)
- for companies that are not listed (including subsidiaries of listed companies), persons who are directors of the company or who hold any other office connected with the management of the company and are also a director of the company or a related company.

The legislation also extends the provisions to where the retiree has at any time in the previous three years held a 'managerial or executive office' in a company or a related body corporate.

Problems with expanded application

Large listed companies can have hundreds of non-listed subsidiaries in Australia. For example, BHP Billiton has over 200 (most of which are in Australia); ANZ has almost 100; Commonwealth Bank has in excess of 500 (most of which are in Australia), and Rio Tinto has approximately 300 subsidiaries. These listed companies will be subject to the legislation in respect of their subsidiary directors and executives.

The directors of the wholly-owned subsidiaries are often employees of the parent company, for example, general managers. These persons are often not senior at the scale of the parent company and their potential termination payments are not at a level that would concern shareholders in the parent company or the community. However, if the definition of 'termination benefit' is extended to catch all types of payments, including accrued annual and long service leave and salary sacrificed into superannuation, the calculation of termination payments to these executives could result in a payment larger than one year's fixed salary.

CSA believes that shareholders are most concerned with termination payments to the CEO and very senior executives of the parent company.

CSA cannot point to any public benefit or benefit to shareholders in imposing a new and onerous regulatory burden on companies that would require shareholder approval of termination payments of general management in the parent and subsidiary companies. As the persons caught by the extended definition are not those whose remuneration has caused any community or shareholder disquiet, CSA believes that it is an unintended consequence of the draft legislation that shareholder approval of their termination payments is now contemplated.

CSA does not believe that shareholders should approve the termination payments of the directors and executives of wholly-owned subsidiaries unless they are listed as key management personnel or the five most highly remunerated executives in the remuneration report.

CSA notes that, if the definition of 'termination benefit' specifically excludes all payments related to length of service, extending the application of the legislation becomes less of an issue.

CSA recommendation that shareholders be given the opportunity to approve a policy on termination payments

CSA understands that the proposed legislative reform aims to capture exit payments that do not reflect performance and those that enrich executives at the expense of shareholders and others.

CSA agrees that shareholders should be able to approve or reject a termination payment to departing CEOs and senior executives above the proposed one-year limit.

However, CSA believes that waiting till the next AGM to approve a termination payment could present significant practical difficulties. If the AGM is many months away, and calling an EGM for the purposes of seeking shareholder approval is specifically prohibited, uncertainty rather than certainty will ensue. This will affect the negotiation of new contracts.

The draft legislation provides that the shareholder vote must be held at the next AGM after the director or executive has departed to ensure that shareholders are in a better position to exercise an informed vote. The stated justification for this is to ensure that shareholders are in a better position to assess whether the proposed termination benefit is appropriate, as shareholders would have an understanding of how the director or executive has performed before exercising their vote. As the Bill prohibits companies from calling an EGM for the sole or dominant purpose of holding the vote on the termination benefit, it is possible that shareholder

judgment might be delayed for many months (12 months between AGMs as well as the statutory requirement for a 28-day notice period for listed companies), by which time that judgment could be clouded by any number of issues beyond the control of the departed executive. In addition, in certain circumstances of retirement, such as ill health or death, undue delay in obtaining approval could be unreasonable. The legislative provisions may also bring unwanted consequences for retirees or employees made redundant, who may have to wait many months to access their retirement benefits and redundancy payments.

CSA also points to the reality that shareholders are unlikely to approve *any* termination payment above one year's fixed salary, no matter how legitimate, some time after the employment relationship with a company has been severed.

CSA believes that there is an alternative approach that is workable.

CSA recommends that a practical approach to ensuring that the proposed law reform achieves the policy objective is to:

- permit companies to submit to shareholders for approval, every three years, a termination policy for key management personnel, to the extent that it may contain benefits outside the legislation — at the end of the three-year period shareholder approval will need to be renewed
- clarify that the termination policy as approved by shareholders will not include payout figures, given that the figures will be unknown until the time of termination or resignation, or contracts have yet to be entered into following new appointments — that is, shareholders will be approving a formula or formulae
- require any termination payment outside the approved policy and formula to obtain shareholder approval as currently drafted.

CSA expects than when seeking shareholder approval of a termination policy, companies would provide in the relevant notice of meeting examples of the quantum amount in relation to that formula for each key management personnel and five most highly remunerated executives based on existing rates of pay in the annual remuneration report.

Payments within the approved formula would be permissible and would not require the specific approval of shareholders. Shareholder approval would be required for any payments outside the approved policy.

This is a principles-based approach, which is in line with Australia's governance framework generally. It is based on exception reporting and would require boards to explain to shareholders why they are seeking to provide any termination payment outside the approved termination policy.

CSA also notes that by having shareholders approve a termination policy, companies will not be required to wait until the annual general meeting (AGM) is held to obtain shareholder approval whenever any executive to whom the legislation applies exits the company, unless the board proposed to provide a termination payment outside the terms of the policy.

CSA's recommendation is based on our members' belief that:

- a principles-based approach is more likely to achieve the policy objective and is consistent with Australia's governance framework
- shareholders are provided with a level of control in the remuneration process and the payment of any termination benefits
- the costs of obtaining shareholder approval for specific termination payments (at shareholder cost) are minimised.

Other areas of concern with legislation

The Exposure Draft sets out the application of the legislation as follows at clause 41:

> (1) The amendments made by Part 1 apply in relation to resignations of offices, or positions of employment, held under agreements entered into, or extended, on or after the commencement of that Part.

The government has stated that the amendments are said not to apply retrospectively to 'existing contracts that have already settled'.

We have two concerns in relation to this:

1) The amendments as set out above need to apply not just to 'resignations of offices' but also to 'termination' as defined in s 200A(1)(e), namely (i) loss of office; (ii) resignation; (iii) death.

2) A recent case suggests that there could be a tension between the intent of the legislation to not apply retrospectively and payments made in relation to existing contracts at some time after the legislation comes into effect. In *Silver v Dome Resources* ([2007] NSWSC 4550 Hamilton J noted that 'I am of the view that what is forbidden where the benefit is in the form of a payment is the making of the payment. The agreement to make the payment is not forbidden, nor does the prohibition arise at any time before the payment actually comes to be made'. The issue was agreed on the appeal (*Dome v Silver*) in a judgment delivered on 27 November 2008. CSA believes that there needs to be certainty that the legislation will not apply retrospectively to existing contracts which have already been settled and recommends that the government clarify the effect of this decision on payments made on existing contracts after the law comes into effect.

Finally, there is a difficulty attached to averaging the base annual salary over three years (if the relevant period is three years or more) as a reasonable estimate of the amount the executive would have earned from the company and related bodies corporate during the relevant period. This does not take into account a change in position that may occur for a particular executive, for example, an executive could be promoted to CEO. The legislation needs to base the annual salary on the executive's position or equivalent position held, not on an earlier more junior position.

Recommendations of good practice

Regardless of legislation, it is, ultimately, a matter for the board to address shareholders' concern to prevent termination payments that are seen to be 'rewards for failure'.

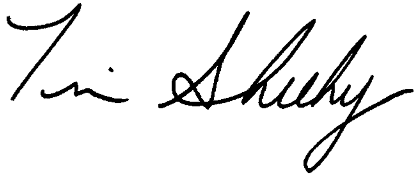
CSA recommends that it is good practice for boards to:

- ensure that there is a clearly agreed contractual right to terminate the CEO and any senior executives appointed by the board
- ensure that the contractual rights for CEOs and executive directors are fully disclosed to shareholders
- ensure that all vesting rights attaching to equity incentives are publicly disclosed at the time the CEO enters into a contract
- ensure, where an executive departs prior to a vesting date, that long-term incentives are limited on a pro-rata basis to the period served and that any entitlements are measured as far as possible on the original performance targets
- not shirk their responsibilities to dismiss poor performers without additional payments.

Conclusion

In preparing this proposal for a practical and workable implementation of policy, CSA has drawn in particular on the expertise of its two internal national policy committees, comprising company secretaries from a range of listed and unlisted public companies. We would welcome the opportunity to meet with you to discuss any of our views in greater detail. Please call me if you would like to set up a meeting. I can also arrange a meeting with our members.

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE