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Attention: Executive Remuneration Inquiry
Productivity Commission
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By email: exec.remuneration@pc.gov.au

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Thank you for the opportunity to comment on the issues raised in the Productivity Commission's Issues Paper on "Regulation of Director and Executive Remuneration in Australia". RiskMetrics (formerly Institutional Shareholder Services) is the world's largest governance advisory firm, providing governance research to more than 1700 institutional investors in Australia and around the world.

Executive remuneration is an important issue for shareholders large and small. It is widely accepted by commentators and regulators around the world that poorly designed incentive arrangements contributed to excessive risk-taking in financial institutions and contributed to the Global Financial Crisis. In Australia, many shareholders have expressed frustration at the apparent lack of connection between executive remuneration levels and company performance over time. This frustration, as noted by the Commission, has manifested itself in increasing willingness on the part of shareholders, especially institutional shareholders, to vote against remuneration related resolutions.[1] In 2008 at S&P/ASX 200 listed companies, there were 58 remuneration related resolutions where more than 20 percent of shares voted dissented from the management recommendation.

Some members of company management have expressed frustration that executive pay receives a disproportionate level of attention given that in most companies it is not a material expense. RiskMetrics acknowledges that there are broader governance issues worthy of shareholder and community attention, such as the issue of director competence and accountability. Executive remuneration however is important to shareholders because it gives an insight into the relationship between the board and the executive team they are responsible for overseeing, and because it is often used to link executive actions to a company's strategy. As such, a company's executive remuneration practices provide meaningful information to shareholders. In some cases, based on recent experience in Australia and around the world, it appears that poorly designed incentive structures contributed to the demise of companies, illustrating that while executive remuneration may not be material as an expense it may create material risks.

RiskMetrics has not attempted to address all of the issues raised by the Productivity Commission in its Issues Paper. The submission does however follow the Commission's terms of reference. It is written from a shareholder perspective and does not attempt to address the issues raised by the Productivity Commission with regards to remuneration in a general community context. As an observation, RiskMetrics considers that to address issues of alignment between executive remuneration and shareholders, governments should respond by empowering shareholders and that

[1] It is apparent that in most cases, substantial votes against management are due to institutional shareholders. As an example, in 2008, Oxiana noted that a majority of shareholders (as opposed to shares voted) had supported the payment of a $10.667 million termination payment to its retiring CEO. See Oxiana Limited, 'General Meeting 2008', ASX announcement, 18 July 2008, page 32, available at http://www.asx.com.au/asx/statistics/announcements.do?by=asxCode&asxCode=OXR&timeframe=Y&year=2008.

the best way to address community concerns over levels of executive pay is through the taxation system.

Finally, RiskMetrics has produced several pieces of research in recent years on the subject of executive remuneration. These have been supplied to the Commission along with this submission and referred to where appropriate.

Term of reference 1: Trends in remuneration

Pay levels and composition

As noted in the Issues Paper, senior executives of Australian companies have enjoyed substantial remuneration increases over the past decade. This has included substantial increases in fixed pay (in the order of 96 percent between 2001 and 2007 for the median CEO of a top 100 company) and substantial increases in bonuses (the median bonus for a top 100 CEO increased from $377,936 in 2001 to $1.334 million in 2007). It is important to note that these increases reflect real cash increases and not just notional accounting values. It also appears that bonuses have become more common; whereas in 2002, one-quarter of top 100 company CEOs received no bonus, in 2008, according to figures from PricewaterhouseCoopers, 94 percent of S&P/ASX 100 senior executives received more than half of their target bonus.[2] Some media commentators have wondered whether annual bonuses in recent years have become "base pay in drag".[3] As noted below, it is not possible based on present disclosures made by most listed companies to determine the extent to which annual (usually cash) bonuses are based on performance.[4]

Trends over the past decade on equity pay are harder to identify, in part because of the various changes to disclosure requirements for equity incentives granted to executives between 2001 and 2007. The aggregate accounting value for CEO equity incentives disclosed by top 100 companies in 2001 was $40,076,982; in 2004, the first full reporting year after ASIC had clarified that it interpreted the Corporations Act to require disclosure of the accounting value of equity incentives by listed companies, the aggregate annual amortised value of equity incentives disclosed for CEOs of top 100 companies was $45,194,357; this had more than doubled by 2007 to $92,742,830. The make up of the type of incentives granted has also changed, as well as the quantum. In 2004, options accounted for 50.46 percent of the disclosed value for top 100 CEOs and this had fallen to 38 percent by 2007. Options with a market based exercise price have increasingly been replaced by zero exercise price options (ZEPOs), which in 2004 accounted for 47.92 percent of the disclosed value for top 100 CEO equity pay and in 2007 for 60.23 percent.[5]

Care should be taken in interpreting figures based on disclosed accounting values. Research by RiskMetrics covering equity incentives that were exercised by CEOs between 2002 and 2006 revealed that the disclosed accounting value seriously understated the value realised by almost all CEOs.[6] It should be noted this research covered a period of generally rising share prices and it is possible that in a negative market environment the disclosed value may be higher than the realised value. The shift away from options with an exercise price to ZEPOs since 2004 does however mean that should executives actually meet the performance hurdles to which equity incentives are subject they are more likely to receive a benefit as ZEPOs do not have the 'built in' hurdle of an exercise price.

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[2] PricewaterhouseCoopers, *Executive Remuneration: Fit for the Future?*, 2009 edition, page 8.

[3] *The Age*, 'Where to after the fall?', transcript of roundtable discussion on executive remuneration available at http://business.theage.com.au/business/where-to-after-the-fall-20090320-94ko.html.

[4] As an example, former Telstra CEO, Sol Trujillo, received 86.04 percent of his maximum bonus in 2006; 88.56 percent in 2007 and 86.04 percent in 2008 (no data is presently available for the 2009 year). This indicates a considerable degree of consistency in bonus outcomes over this three year period.

[5] Figures from ACSI, *CEO Pay in the Top 100 Companies: 2007*, Research paper prepared by RiskMetrics. The Commission already has this paper.

[6] See attached research paper, "CEO pay: It's even higher than you think".

Explaining trends in executive pay

The Issues Paper asks whether current executive and director remuneration levels are justified. From a shareholder perspective, the upwards trend in executive remuneration is justifiable if it reflects improved returns to shareholders and current levels of executive pay are justified if they reflect the levels required to attract, retain and motivate senior executives bargaining on arm's length terms with boards as representatives of the company and shareholders.

Returns to shareholders

As noted by the Productivity Commission, it is accepted by all participants in the debate over executive pay that pay levels have increased substantially over the past decade. For these increased pay levels to be acceptable to shareholders they should reflect improved returns. RiskMetrics has created eight case studies of CEO cash pay at large, well known Australian companies across the tenure of a recent CEO. The case studies relate cash pay to reported profits on the basis of how many dollars of profit each dollar of cash CEO pay generates as a measure of productivity, with this 'profit per dollar of cash pay' measure adjusted to account for inflation and compared with the productivity of each CEO's predecessor. These case studies are not meant to provide a comprehensive review of the link between increases in executive pay and returns to shareholders but to suggest a potential area of further research for the Productivity Commission to assess the extent to which executive pay increases have reflected improved shareholder returns.

Case studies: Profits generated by dollar of cash CEO pay

Company	CEO	Cash pay of predecessor in last full year	Predecessor profit per dollar of cash pay	Cash pay of CEO in last year	Profit per dollar of cash pay	Change in profit per dollar of CEO cash pay
Aristocrat	P Oneile	$3,274,056 (2002)	$28.11	$3,215,139 (2007)	$76.88	173.5%
Macquarie Group	A Moss**	$3,682,570 (1999)	$59.65	$27,894,726 (2008)	$64.64	8.37%
NAB	J Stewart	$3,344,151 (2003)	$1,384.76	$4,457,446 (2008)	$1,017.62	-26.51%
Qantas	G Dixon	$2,099,857 (2000)	$321.31	$5,615,408 (2008)	$172.56	-46.29%
QBE	F O'Halloran	$1,145,000 (1997)	$185.26	$5,463,000 (2008)	$332.78	79.63%
Santos	J Ellice-Flint	$1,622,532 (1999)	$245.77	$4,748,972 (2007)	$92.78	-62.25%
Suncorp	J Mulcahy	$1,759,999 (2002)	$211.38	$3,200,337 (2008)	$173.73	-17.81%
Telstra	S Trujillo	$3,918,107 (2005)	$1,258.89	$5,905,401	$625.19	-50.34%

*Note: Predecessor profit per dollar of cash pay adjusted for inflation using ABS CPI All Groups index data.
**Note: For Moss, the comparator is with his reported remuneration in 1999, the first year his reported remuneration was available.

RiskMetrics also notes that company performance can be measured in a variety of ways outside of headline profit and share price performance. Performance in the case studies was also assessed on the basis of return on assets (ROA), return on equity (ROE) and total shareholder return. In the case of Suncorp, Santos, NAB and Macquarie, ROA and ROE both fell across the relevant CEO's tenure; in the case of Aristocrat and QBE both measures improved and in the case of Telstra and Qantas, one

measure fell and one measure rose. In five of the eight cases (Qantas, QBE, Santos, Aristocrat and Macquarie) total returns to shareholders were positive over the CEO's tenure.

It should also be noted that actions by an executive team may take time to flow through into returns to shareholders as major investments may generate benefits years later. General economic conditions may also have a major impact on company performance, although both these caveats reveal the hazards in trying to attribute company performance to individual executive actions. Based solely on the case studies above it appears difficult to argue that general increases in cash executive pay have produced greater returns to shareholders; in five of the eight case study companies, inflation adjusted dollars of profit per dollar of CEO cash pay fell over the tenure of the most recent CEO. Productivity improvements do not appear to explain executive pay increases, despite all CEOs in the case studies receiving performance based cash bonuses explicitly disclosed as being tied to performance.

The market for executive talent

Most justifications for the increases in executive remuneration levels over the past decade are that such increases reflect the demand for highly skilled executives in a competitive market and are the results of arm's length bargaining. Some commentators (and directors of large companies) also argue that the requirement to disclose executive pay levels over the past decade has contributed to an escalation in pay levels due to improved information among executives about relative pay information. Many of these views appear to be based on the assumption that as participants in the executive labour market – companies and executives – are profit-seeking entities, pay outcomes must reflect a functioning market. Some of the major characteristics of a properly functioning market are:

- **Low barriers to entry/mobility:** In the case of executive labour markets, the potential group of people qualified to be an executive of a large listed corporation is obviously much smaller than the general labour market. In a functioning market, the increase in the 'price' for an executive over the past decade would suggest either a reduction in the potential supply of executives or an expansion in the number of potential purchasers. It is not clear that this is the case.[7]
- **Widespread information availability:** The requirements for executive pay disclosure over the past decade have improved publicly available information for market participants. The increase in pay levels over the past decade may therefore reflect this improved information, enabling executives to attract a higher price for their labour. This argument is based on the assumption that in a small market such as Australia senior executives (and boards of directors) were not aware of executive remuneration levels at other listed companies prior to the requirement for pay disclosure. Surveys of remuneration levels for senior staff at law firms, investment banks and professional services firms, regularly published in the media, indicate that just because information is not formally disclosed does not mean that it is not available or is not widely known.
- **Absence of externalities:** In a functioning market, the costs of purchasing a service are borne by the purchaser. In the case of the executive labour market for listed companies, the purchasers are boards of directors or management acting on behalf of companies. Potential costs are therefore not borne by the purchasers, but by shareholders of the company (other than reputational damage to individuals). It should also be noted that outside of a handful of cases, executive pay levels are not material in the context of listed corporations. This means that there is little incentive for purchasers of executives to minimise the cost of executives – outside of reputational concerns – because such costs will not substantially impact on overall profitability.

[7] RiskMetrics, in its discussions with listed companies, is routinely informed that remuneration increases reflect a competitive market for senior executive talent, although to date, RiskMetrics is unaware of any empirical evidence suggesting that the market for senior executive talent has become 'tighter' over the past decade.

- **Price competition:** A functioning market is also characterised by price competition, including suppliers reducing prices in order to attract a purchaser. There is little public evidence that price undercutting by candidates occurs in the executive labour market. It is also difficult to determine the extent to which bargaining over price occurs as part of negotiations over recruitment of senior executives. The actual process by which executive remuneration levels are set is not generally visible to shareholders or other external observers and so it is difficult to comment on the extent to which boards and management teams are willing to negotiate over remuneration levels. From public disclosures, it appears that many companies use comparative data drawn from other companies in setting and reviewing executive remuneration levels. This practice is similar to the now discredited (for general labour markets) concept of 'comparative wage justice': The belief that remuneration levels should move at similar rates across different companies and roles to ensure relativities are maintained across the economy, regardless of the circumstances of individual companies.

One unchallenged belief in the executive labour market is that companies must offer the highest possible levels of remuneration to obtain the best candidates (often expressed in the converse, that if a company 'pays peanuts, it gets monkeys'). On this basis, the highest paid executives in Australia should over time prove to be the best performers. Recent evidence suggests that this does not appear to be the case.

Highest paid Australian CEOs 2005 to 2007

2005	2006	2007
Allan Moss (Macquarie)	Allan Moss (Macquarie)	Allan Moss (Macquarie)
Frank Lowy (Westfield)	Phil Green (Babcock & Brown)	Phil Green (Babcock & Brown)
Wal King (Leighton)	Frank Lowy (Westfield)	Frank Lowy (Westfield)
Leigh Clifford (Rio Tinto)	Wal King (Leighton)	Wal King (Leighton)
Roger Corbett (Woolworths)	Roger Corbett (Woolworths)	Paul Little (Toll Holdings)
David Morgan (Westpac)	Charles Goodyear (BHP Billiton)	Greg Clarke (Lend Lease)
John McFarlane (ANZ)	Sol Trujillo (Telstra)	Sol Trujillo (Telstra)
David Turner (Brambles)	David Turner (Brambles)	Paul Anthony (AGL Energy)
Greg Clarke (Lend Lease)	David Morgan (Westpac)	Charles Goodyear (BHP Billiton)
Charles Goodyear (BHP Billiton)	John Stewart (NAB)	David Morgan (Westpac)

The table above, based on disclosed remuneration, indicates several problems with the 'pay the most, get the best' argument: First, the group of individuals representing the 10 highest paid CEOs in Australia was relatively stable over this period, consisting of 15 individuals over three years. It is possible that this indicates that this cohort of individuals is truly exceptional; it is also equally possible that it indicates factors other than performance contribute to their remuneration levels – for example, three of the 15 individuals, Phil Green, Frank Lowy and Wal King, were long serving executives and their remuneration may in part reflect the benefits of incumbency.[8] Second, three of the 15 individuals – Green, Paul Anthony and Sol Trujillo – have departed their roles with questions over the performance of the company under their tenure (in the case of Green, Babcock

[8] RiskMetrics in 2008, as part of the research paper reviewing the remuneration of the top 100 company CEOs in Australia, reviewed the remuneration levels of incumbent CEOs compared with those of newly appointed CEOs. The incumbent CEOs in the sample (those in office for the entirety of the survey year and the prior year) received higher fixed pay, higher bonuses and higher total reported remuneration, as well as higher rates of increase in fixed pay, bonuses and total pay. See page 17, n. 3 above.

& Brown entered voluntary administration on 13 March 2009 after he stepped down as CEO on 21 August 2008) and in several other cases, the performance of the company under the individual involved is open to debate.

Terms of reference 2, 3 & 4: The effectiveness of the existing framework, the role of shareholders and mechanisms to improve alignment

This part of RiskMetrics' submission deals with the governance framework of Australian companies as the framework within which executive pay is determined. RiskMetrics does not consider it appropriate in this submission to comment on specific remuneration arrangements (such as pay practices that may improve or reduce alignment with shareholders) as such arrangements are necessarily company specific. On this basis, it is more constructive to instead focus on ways of empowering shareholders to effectively scrutinise existing remuneration arrangements and ensure they are able to effectively seek change if these arrangements are unpalatable.

It is difficult to separate the process by which executive remuneration is set, and the role of shareholders in this process, without considering the entirety of the framework through which listed companies are governed. In part, this is because the actual legal role of shareholders in setting executive pay is limited (see below).

The governance framework for Australian listed companies is, in RiskMetrics view, generally strong, subject to certain potential problems identified below. This robust framework avoids many of the problems encountered in the United States, where many basic features of Australia's governance environment – the ability to remove directors with a majority vote of shareholders, the statutory right of shareholders to put resolutions to general meetings and nominate candidates to the board and the doctrine of "shareholder primacy" in takeover law - are absent. Australia's framework provides a major check against management entrenchment as shareholders have ample remedies against management teams that underperform or are excessively self-serving.

Shareholders in Australia, under a combination of statute and case law, are also afforded protection against board and management wrongdoing by key provisions of the Corporations Act laying out the duties of directors (sections 180 to 183), and their general law counterparts. This is well illustrated by leading cases such as *Adler v ASIC* [2003] NSWCA 131, *ASIC v Maxwell* [2006] NSWSC 1052, *ASIC v Sydney Investment House* [2008] NSWSC 1224 and, most recently, *ASIC v Macdonald (No 11)* [2009] NSWSC 287.

These arrangements, however, are designed to deal with exceptional circumstances, namely that of misconduct of a director or executive in relation to the discharge of their duties to their company or compliance with statutory obligations. As indicated above, in cases of alleged underperformance on the part of directors and management or unhappiness with the manner in which a company is being managed, the principal 'remedy' available to shareholders is the self-help remedy of voting, for example, by voting out members of the board or voting down proposals put to the shareholders by the board (including voting down remuneration reports).

Outside of the general governance framework, however, and as noted in the Commission's Issues Paper, shareholders have a limited role in the executive remuneration framework:

- Shareholders have an advisory or non-binding vote on the remuneration report;
- They have a binding vote on termination payments to directors above a certain threshold and subject to a variety of exceptions;
- The ASX Listing Rules confer shareholders the right to approve the aggregate fees that may be paid to directors in their capacity as directors (executive director remuneration as a result is not included in this approval) and to approve the issue of equity securities to directors.

The Corporations Act contains two other mechanisms that ostensibly allow shareholders a prominent role in relation to the remuneration of directors (executive and non-executive). These two mechanisms are, however, in their current form, effectively useless:

- Section 202A provides that directors are to be paid the remuneration that the company determines by ordinary resolution. This is a “replaceable rule” and is therefore entirely optional for companies; and
- Under Chapter 2E, the shareholders of a public company must approve financial benefits paid by that company (or an entity controlled by it) to a “related party”. Directors of the company are related parties of a public company.

The Act exempts “reasonable” remuneration paid to a related party from the requirement under Chapter 2E to obtain shareholder approval (section 211).

The closest the Australian courts appear to have come, to our knowledge, to evaluating the scope of the section 211 exception is in *Dome Resources NL v Silver* [2008] NSWCA 322. The NSW Court of Appeal stated that, in determining the remuneration that would require disclosure to shareholders (and also their approval) if section 211 was inapplicable, regard had to be had to the economic and commercial substance of the dealing in question. The court did not comment on what would constitute reasonable remuneration or when remuneration would not be covered by section 211.

RiskMetrics also notes that, in the absence of either regulatory or judicial guidance on the scope of section 211, it is open to directors of companies to defend their conduct in relation to pay-setting simply through the adoption of a recommendation from a remuneration consultant, by mimicking the remuneration practices of industry peers or receiving formal advice from a consultant that their arrangements are ‘reasonable’. On this basis, remuneration that may not be ‘reasonable’ in the context of a specific company or of the market generally can be deemed reasonable simply because it resembles the practices of other companies.

Recommendations for change: Specific to pay

RiskMetrics recommends that the Commission, consistent with the Treasury’s approach in relation to reforming the regulatory framework for termination payments, consider re-enfranchising shareholders in several areas:

- **Approval of equity securities to executives:** Changes to ASX Listing Rule 10.14 in October 2005 have removed shareholders’ ability to prevent directors obtaining equity securities on terms not available to other shareholders. These changes, which were consistent with numerous waivers to Rule 10.14 granted over several years prior to 2005, exempted from the requirement for shareholder approval securities granted to directors that had been purchased on market using company funds. The stated reason for this change was that if securities were purchased on market, no dilution occurred.
- This appears to be a simplistic interpretation of dilution as the concern over dilution with related parties is that they are able as a result of their ‘insider’ status to increase their share in the company on terms unavailable to other shareholders. Allowing boards to use shareholder funds to purchase securities on behalf of directors in the absence of shareholder approval creates a significant potential for abuse. RiskMetrics also notes that the ASX consulted over shareholder views on this change as part of a consultation process conducted by the ASX Corporate Governance Council in 2007; from the submissions viewed by RiskMetrics it appeared that groups representing shareholders wished to have the ‘on market’ exemption removed from the Listing Rule and that those submissions made by the management of listed companies, or bodies representing company management, wished to have the exemption retained. As at the date of this submission, ASX Listing Rule 10.14 remains as amended in 2005.
- As such, RiskMetrics recommends that in order to remove the potential for abuse under the present Rule, all grants of equity securities to directors of listed companies should be subject to shareholder approval, and that this requirement be included in the Corporations Act. Given the increasing prominence, powers and importance of senior executives below board level, RiskMetrics also recommends that any grant of equity securities to members of key management personnel (those executives whose remuneration is disclosed in the remuneration report) also be

subject to shareholder approval. This change would be consistent with the Government's planned changes to the approval regime for termination payments which include as a payment requiring approval the accelerated vesting of equity securities to members of key management personnel on termination. It would be inconsistent to require the approval of equity securities received by key management personnel as a consequence of termination but not to require approval of these equity securities at the time of grant.[9]

- **Disclosure of remuneration consultants:** There has been considerable public comment on the role of remuneration consultants in setting executive pay, and calls for greater regulation of remuneration consultants in jurisdictions such as the United States and the UK.[10] RiskMetrics considers that in Australia, where directors act as agents of shareholders in setting executive pay, attention on the role of remuneration consultants is misplaced as the ultimate responsibility for executive remuneration lies with the board. Any major regulatory intervention aimed at the role of remuneration consultants may blur the accountability of the board for decisions on remuneration (RiskMetrics notes that in its engagement with listed companies on behalf of institutional investor clients it is relatively common for boards to justify decisions not on the basis of what the directors consider to be appropriate but as being consistent with advice received from remuneration consultants).
- In the interests of transparency therefore, RiskMetrics considers that the Corporations Act should be amended to require that if a board, in the remuneration report, explicitly notes that it has relied on external advice in setting an aspect of executive remuneration, then the identity of that advisor should be disclosed.
- **Termination payments:** RiskMetrics is generally supportive of the Australian Government's proposed amendments requiring shareholder approval of termination payments to members of key management personnel in excess of 12 months fixed pay, and will be making a separate submission to the Treasury consultation process on the proposed changes.[11] RiskMetrics notes that it is puzzling that many directors have publicly argued that they oppose this change on the basis that it will force increases to base pay, apparently on the basis that talented executives will only join a company if they can be guaranteed sums that would presently be in excess of 12 months base salary on termination. This risk could be mitigated by amending the proposed legislation so that any payment that is in excess of the lower of 12 months base salary and $500,000 (or some other figure, perhaps indexed to average or median income) be subject to shareholder approval.
- **Remuneration report voting:** The primary role of the non-binding remuneration report is to allow shareholders to convey their view of a company's remuneration practices to the board. As such, it appears counterproductive to allow members of key management personnel to be able to vote on this resolution as allowing them to vote distorts the actual level of support among its shareholders that a company's remuneration practices enjoy.
- RiskMetrics therefore recommends that the Corporations Act be amended to specify that those executives and directors whose remuneration is disclosed in the remuneration report be precluded from voting on the resolution relating to the remuneration report.
- **Taxation:** At present, the tax rules in Australia allow a senior executive (and other recipients of grants of equity under employee share schemes) to legally minimise taxation, by electing to 'pre-pay'[12] income tax on a specified percentage of the accounting value of the equity incentive instrument in advance of any actual value being realised. The amount of tax to be pre-paid depends on the structure of the incentive and its life, but may be much lower than the total

[9] Please see attached discussion paper for a more detailed review of the potential problems with Listing Rule 10.14 as it now stands.
[10] See, for example, the recommendations of the House of Commons Treasury Committee, discussed in the appendix.
[11] Please see attached summary of recent termination payments.
[12] See section 139E and Section 139FN of Income Tax Assessment Act 1938

amount that would be payable if the equity incentives substantially increased in value. By electing to pre-pay, executives cap the amount of income tax assessable and may then be able to qualify for the capital gains tax concession on any increase in share value or disposal of the equity incentive instrument itself (commonly through the cancellation of options). If the equity instrument turns out to be valueless, income tax paid in advance may be refundable. If no prepayment election is made taxpayers can also receive an advantage by deferring the tax payable on vested equity securities until they formally take possession of the underlying equity (normally through exercise). At this point the full value of the gain would be assessable as income, (RiskMetrics notes that the ATO reportedly has evidence of widespread underreporting of gains as income amongst taxpayers earning more than $1 million).[13] The principal advantages accruing to taxpayers who participate in these schemes (or variations thereof) arise through the prepayment mechanism and the application of the CGT concession. This can lead to an executive paying a much lower rate on total gains accruing from equity pay (as low as 26 percent). As an example, RiskMetrics is aware of one case, at Toll Holdings, where holders of yet-to-vest, at risk options that were cancelled as a result of a demerger were not only compensated for the loss of these options but were also compensated for the additional tax they were required to pay as a result of having options replaced with cash.

- The differential tax treatment of equity pay can have distorting effects on overall executive pay practices, as it may create an incentive to set performance hurdles or options values to optimise after-tax take home pay at the expense of long term shareholder gains. Tax neutrality of all forms of executive pay avoids this problem.
- Evidence from the US suggests that differential taxation regimes for elements of executive pay can lead to distorted outcomes harmful to shareholders.[14] To avoid potential distortion in executive pay outcomes, the tax-advantaged status of equity grants that do not represent purchases by executives out of post-tax income should be removed.

Binding votes on executive pay

Several countries, such as the Netherlands, Sweden, Norway, France and Spain, have binding votes on company executive remuneration practices. In Australia, the Opposition Leader has called for the remuneration report vote to be made binding.[15] RiskMetrics does not consider that it is feasible to make the present vote on the remuneration report in Australia binding given it would encompass a range of aspects of pay – including pay structure and policies, quantum and relationship to performance. Shareholders sufficiently concerned over a company's remuneration practices have the right under Australian law to vote against or move the removal of directors responsible for these practices.

There is however a distinction between seeking binding approval from shareholders on a company's remuneration policies and outcomes generally and on allowing shareholders a binding vote on the total quantum that may be paid to directors and senior executives. RiskMetrics has no firm view on requiring shareholder approval of the total quantum that may be paid to directors and executives, and shareholders who consider total pay levels to be excessive are at present able to vote for the removal of the directors responsible. Significant precedent does however already exist in Australian

[13] *The Australian Financial Review*, 'ATO checks reveal unreported millions", 21 May 2009 – revealed that 8% of 1300 executives earning more than $1million failed to report an average of $180,000 of income from equity incentive arrangements.

[14] In the US, severance payments above a certain threshold on a change of control are subject to a 20 percent tax and it is common for executives to receive payments to compensate them for any additional tax incurred. See RiskMetrics, *Gilding Golden Parachutes: the Impact of Excise Tax Gross-Ups*, October 2008, available at http://www.riskmetrics.com/docs/2008ExciseTax.

[15] See Malcolm Turnbull MP, Address to the National Press Club, 25 November 2008, available at http://malcolmturnbull.com.au/Media/Speeches/tabid/91/articleType/ArticleView/articleId/98/categoryId/5/Address-to-the-National-Press-Club.aspx

law for requiring shareholder approval of the quantum that may be paid to directors, usually under related party provisions, including section 202A of the Corporations Act; the requirement for all payments not on arm's length terms and outside of "reasonable remuneration" to directors to be approved by shareholders and the requirement under the Listing Rules for the maximum aggregate remuneration of directors to be subject to a shareholder approved cap, all noted above.[16]

As such, giving shareholders the right to approve the total quantum of executive remuneration would be able to be readily accomplished within the existing framework of the Corporations Act:

- By narrowing the scope of section 211 (through the inclusion in that section of specific criteria as to what constitutes reasonable remuneration) or simply by repealing section 211; and
- Extending the concept of "related party" beyond "directors" (section 228(2)(a)) to senior executives at the sub-board level. This can be achieved through the adoption of the concept of "key management personnel" from section 300A or a person who holds a "managerial or executive office" from Treasury's draft Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

These changes would allow shareholders to control the aggregate amount paid to directors and senior executives but leave the actual structure of remuneration to the board. In addition, the changes would not affect section 210, meaning that boards – who wish to rely on an exemption to the requirement for shareholder approval – would have to establish that the remuneration proposed is either on "arm's length terms" or on terms less favourable than arm's length terms, tests that appear to be more stringent than the existing test in section 211.[17]

If the Productivity Commission does not consider such changes to be desirable, RiskMetrics would still recommend deleting the "reasonable remuneration" exemption from the Corporations Act, as it is has proven to have little utility. As discussed above, RiskMetrics also considers that given the voting and distribution rights attached to equity securities and the privileged position of directors and senior executives, shareholders should have the right to approve in advance any grants of such securities.

Finally, it should be noted that empowering shareholders to more effectively hold boards accountable for remuneration decisions may potentially improve the ability of boards to act as effective stewards of the company. This is not only because they will be subject to more effective accountability mechanisms as agents but also because limiting their ability to determine executive remuneration in certain key areas without reference to shareholders would improve their ability to bargain with executives.

Recommendations for change: Remuneration disclosure

The present executive remuneration disclosures required under the Corporations Act (and through the Act, AASB 124, dealing with related parties, and AASB 2, dealing with share based payments) are in the main sufficient for shareholder needs. RiskMetrics however considers that in several specific areas the existing disclosure requirements could be improved:

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[16] RiskMetrics also notes that in jurisdictions such as South Korea, the maximum remuneration payable to all directors, executive and non-executive, is subject to a shareholder approved cap, approved annually in advance.

[17] In contrast to section 211, section 210 has been the subject of detailed judicial scrutiny: eg *Orrong Strategies Pty Ltd v Village Roadshow Ltd* [2007] VSC 1and *ASIC v Australian Investors Forum Pty Ltd (No 2)* [2005] NSWSC 267. The courts will, in deciding whether a proposed dealing is on arm's length terms, assess the terms of the proposed dealing against the terms that would reasonably be achieved by a hypothetical public company that, among other things, is concerned only to achieve the best available commercial result for itself in all circumstances. Moreover, the courts have stated that while expert evidence as to what would be within the range of reasonable outcomes may be useful that evidence itself will not be decisive in determining whether the proposed dealing falls within section 210 and the court is not bound to accept such evidence.

- **Share-based payments:** AASB 124 and AASB 2 require listed companies to disclose the value of share based payments to employees, including senior executives and directors. Two shortcomings with the existing requirements are as follows:
  - At present, AASB 2 requires companies to value share based payments differently depending on the type of hurdle applying to the equity instruments. Equity incentives subject to a “market condition” must be valued at the time of grant, taking into account the probability of vesting, and then no adjustment to the fair value recognised may be made regardless of whether or not the equity incentive will vest. Equity incentives subject to other types of hurdles are valued differently, with companies unable to take into account the probability of vesting in determining the fair value. Companies are however able to change the number of equity incentives subject to non-market based hurdles recognised in the financial statements to adjust for the likelihood of vesting. There does not appear any rationale for this differential valuation requirement depending on the type of hurdle used.[18]
  - Companies are also not required to disclose the extent of any discount they apply to equity incentives to take account of the probability of vesting, although other assumptions used in assessing fair value are disclosed. RiskMetrics is aware of only one case where a company has disclosed the discount it applied to take into account the likelihood of vesting.[19] There does not appear to be any compelling reason why the discount applied in determining the fair value should not be disclosed to shareholders.
- As noted above, RiskMetrics has observed that prior to August 2006, the fair value of equity incentives granted to CEOs of large companies was routinely far below the actual realised value.[20] It is not clear whether this represents attempts to ‘camouflage’ the total levels of remuneration paid to senior executives, the effect of a period of generally sharply increasing share prices or a combination of these and other factors. RiskMetrics also notes that it is common for listed companies to grant executives a quantity of equity incentives the fair value of which at date of grant is equivalent to a dollar amount (often expressed as a multiple of base salary). This creates an incentive, especially in the absence of a transparent process for determining the fair value of equity incentives, to minimise the reported fair value of equity incentives in order to maximise the actual number of incentives granted.
- **Termination entitlements:** The Corporations Act requires remuneration reports to disclose the term of service contracts with members of key management personnel, including entitlements on termination (section 300A(1)(e)(vii)). In some cases, the disclosure provided is not clear or the amounts actually paid to a departing executive were substantially larger than indicated in prior disclosures.[21]

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[18] See paragraphs 19 to 21, Australian Accounting Standards Board, *AASB 2: Share-based Payment*, 19 October 2007.

[19] The company was Telstra which in its 2006 annual report disclosed that the company expected only 15 percent of equity incentives granted to senior executives to vest. See Telstra, *2006 Annual Report*, p. 235.

[20] As an extreme example, in its 2008 annual report, Cromwell Group disclosed that the fair value of more than 2 million options granted to executives with a market based exercise price was zero. Cromwell Group, *2008 annual report*, page 19.

[21] For example, Adelaide Bank in its 2005 annual report disclosed that the then-CEO, Barry Fitzpatrick, was entitled to one month’s notice on termination, statutory entitlements and that the board had discretion to direct forfeiture of any unvested entitlements. On 19 July 2006, Adelaide Bank announced Fitzpatrick would retire in December 2006 and on 12 September 2006 that he would receive a “retirement payment” of $8.3 million in addition to superannuation and statutory entitlements, representing 9 percent of 2006 net profit. See Adelaide Bank, *2005 Annual Report*, p. 31; the ASX announcements are available at

- It is also notable that executives of listed companies are routinely described in audited reports to shareholders and in announcements to the ASX under continuous disclosure requirements to have resigned or retired. The public description of the circumstances of their departure does not however appear to bear any relation to the types of payments they receive on departure. A review by RiskMetrics of the 25 CEO departures at S&P/ASX 20 companies as at May 2009 over the period 2000 to 2009, found no cases where a CEO was disclosed as being terminated. The most information provided on the reasons for a CEO's departure was by BHP Billiton in the case of Brian Gilbertson, whose January 2003 departure was described as a resignation following "irreconcilable differences" with the board. In all other cases disclosure indicated that the departure was voluntary but despite this, in 11 cases, termination payments were made.[22]
- It appears that companies either voluntarily make payments to departing executives which they have no contractual obligation to make or routinely mislead the market on the reasons for CEO departure. This absence of information makes it difficult in many cases for shareholders to assess the reasonableness of payments on departure. In some cases, the reason behind a CEO's departure – such as a disagreement with the board over strategy – is information likely to be considered material by shareholders.
- To improve transparency in the area of termination entitlements, RiskMetrics recommends that the disclosure requirements around termination entitlements be amended so that companies when they disclose payments made to executives who have departed during the financial year are required to disclose under which contractual provisions the payment was made (ie. did it represent payment in lieu of notice by the company, a redundancy payment, a termination payment, etc). Australia should also adopt the US disclosure practice of requiring companies to disclose each year the actual dollar value of payments to which an executive would be entitled on cessation of employment as at the date of the financial year end.[23] This would improve information to shareholders and would also require boards to effectively "stress test" executive termination entitlements on a regular basis.
- **Disclosure of performance hurdles:** The Corporations Act (section 300A(1)(ba)(i)) requires listed companies to provide a "detailed summary" in the remuneration report of the performance conditions applying to any part of key management personnel remuneration subject to performance criteria. Non-compliance with this statutory requirement is routine, especially in relation to annual cash bonuses, and is apparently not policed. RiskMetrics is aware of only a handful of listed companies (such as Newcrest and QBE Insurance Group) that disclose the actual performance conditions that had to be satisfied in order for bonuses to be paid for the prior year (despite the lack of commercial sensitivity around such retrospective disclosure).
- No change to the law is required in this area. RiskMetrics recommends that the relevant government agency, the Australian Securities & Investments Commission (ASIC), more stringently police disclosure in this area or indicate what it considers to be acceptable disclosure under the Act.[24]

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http://www.asx.com.au/asx/statistics/announcements.do?by=asxCode&asxCode=ADB&timeframe=Y&year=2006.

[22] This does not include two cases where CEOs departing at the expiry of their contracts received 'end of contract' payments and another case where a departing CEO had the last three months of his contract paid out.

[23] See, for example, Merrill Lynch & Co, Inc., *2008 Proxy Statement*, 14 March 2008, pp. 48-50, available at http://www.sec.gov/Archives/edgar/data/65100/000093041308001703/c52269_def14a.htm#A025. Arguably the Act already requires this type of disclosure as it states that any "termination payments" to which a member of key management personnel would be entitled under their contract must be disclosed in the remuneration report.

[24] There is a precedent for such a pronouncement; in June 2003 ASIC announced that it interpreted the Corporations Act to require that companies disclose a value for equity granted to executives in remuneration disclosures, and outlined how such values should be calculated and disclosed. See ASIC, 'Valuing options for directors and executives', Media Release, 30 June 2003, at http://www.asic.gov.au/asic/asic.nsf/byheadline/03-202+Valuing+options+for+directors+and+executives+?openDocument.

Recommendations for change: The general governance framework

The fundamental protection afforded to shareholders in Australia is the ability to elect and remove directors. This right also underpins the effective exercise of the remuneration report vote, as shareholders who feel their concerns are being ignored are able to seek the removal of the directors responsible.

There are however a number of aspects of shareholder voting which, under current regulatory arrangements, have the potential to cast doubt over the integrity of the voting process (including aspects specifically relating to the election of directors or resolutions relating directly to executive remuneration). These problems consequently reduce the effectiveness of voting as a means of making directors accountable to their shareholders and may also affect the validity of resolutions generally.

- **The “no vacancy” rule:** A major barrier to shareholders electing their own candidate as a director (as opposed to approving the appointment of a board-endorsed candidate) is a standard clause contained in most listed company constitutions. This clause confers on the board the power to determine the maximum number of directors within the confines of the minimum and maximum number of directors set by the constitution.
- These clauses allow the board in a contested election – typically when a candidate has been nominated by shareholders – to declare that the maximum number of directors is the number of directors presently on the board and, accordingly, there are no vacancies. For the non-board endorsed candidate this means that in order to be elected they must receive not only a majority of the votes cast on their election but also more votes than the board-endorsed candidate seeking election at the same meeting. This power under the constitution may be used in cases where the number of directors on the board is much lower than the maximum number allowed under the constitution.
- As this power to fix the maximum number of directors is contained in company constitutions, it has been “assented” to by the shareholders (although, in many cases, the relevant clause may have been in the constitution since listing, and is deemed to have been accepted by shareholders when they bought into the IPO).
- RiskMetrics recommends that the Corporations Act be amended to state that only the general meeting (that is, the shareholders) has the right to set the maximum and minimum number of directors (subject to the Corporations Act requirement that a public company must have a minimum of three directors) that may hold office at any time. Such a provision would still allow the board to determine the number of directors on the board at any time within the limits set by the constitution. This determination would, however, be subject to the will of shareholders by removing the board’s ability to declare a cap on the number of directors that is within the cap imposed under the constitution.
- It is worth noting that this type of amendment would not confer a new right on shareholders. Shareholders – in general meeting – have the inherent right, unless modified or excluded by the company’s constitution, to determine the maximum number of directors that their company may have.
- **Audit trail for proxy voting:** Under the present proxy voting system, the holders of shares or those entrusted with the exercise of voting rights attaching to shares do not receive from the company or the company’s share registry any confirmation as to (a) the number of votes lodged and voted and (b) the manner in which the votes were cast. This lack of an audit trail means that custodians, fund managers and superannuation funds as well as retail investors are unable to

ascertain whether their proxies have been accepted by the company and exercised in the manner directed.[25]

- RiskMetrics recommends that a meaningful audit trail from companies and their share registries to shareholders be implemented, so that shareholders can have confidence that their voting rights and any voting instructions given by them have been respected by the company.
- **Cut-off date for proxy voting:** Under the present proxy voting arrangements in Australia, there are two cut-off dates that are relevant to the ability to cast votes via proxies: (a) proxy appointments must be received by a company at least 48 hours before a meeting; and (b) the company's determination of voting entitlements for a meeting must be based on the persons who were shareholders not more than 48 hours before the meeting.
- The coincidence of these two cut-off dates creates the potential for discrepancies between the votes lodged via proxies and the votes held at the second of these cut-off dates (as, despite the flexibility in the first cut-off date, the company is effectively required to reconcile the votes lodged with voting entitlements no more than 48 hours before a meeting).
- RiskMetrics recommends that an earlier date for determining voting entitlements – say five business days before the meeting instead of 48 hours – will provide sufficient time for accurate reconciliation of votes lodged with voting entitlements. This will reduce the time pressure for reconciliation and will therefore make it more likely that shareholders' proxy appointments and voting instructions are respected. This will also facilitate the creation of an audit trail.[26]
- **Oversight of votes:** It is also incongruous that, under the current arrangements for shareholder voting, those persons who may have a material interest in the outcome of a shareholder votes should have the responsibility for oversight of that vote (either directly, or indirectly via board-appointed agents such as auditors or share registries).
- RiskMetrics recommends that provisions equivalent to those in the United Kingdom Companies Act 2006 be adopted in Australia, namely that shareholders be given a statutory right to require the board to obtain a report by an independent assessor on any poll taken – or to be taken – at a general meeting of the company (section 342, Companies Act 2006 (UK)).
- **Protecting the confidentiality of votes:** Under Chapter 6C of the Corporations Act, ASIC, a listed company or the responsible entity for a listed managed investment scheme may direct the holder of a relevant interest in the company's shares to disclose certain information. Of primary concern is the ability of a company to direct a custodian to reveal how they have been instructed to vote shares at any particular meeting.
- A custodian can be required, under Chapter 6C, to disclose any instructions it has received from the beneficial owner of the shares (for example, a superannuation fund) or the beneficial owner's fund manager, as to how the shares are to be voted. In its current form, Chapter 6C would require the disclosure of the identity of all beneficial owners of the relevant shares, each beneficial owner's precise holding, when the voting instruction was received by the custodian, and the content of the voting instruction.
- This provision, which has been part of the Corporations Act and its predecessors for more than 20 years, has been cited by firms working on behalf of the management of listed companies to seek

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[25] The need for an effective audit trail is even more pressing in light of *Campbell v Jervois Mining Ltd* [2009] FCA 401 where the Federal Court held, in effect, that the Chairperson's statement of intention in the notice of meeting as to how undirected proxies would be voted was not binding on the Chairperson and the Chairperson could thus validly vote such proxies in a manner contrary to the previously declared intention.

[26] RiskMetrics is aware that the Investment & Financial Services Association has previously raised this issue, and the issue of a voting audit trail in a submission to the Joint Parliamentary Committee on Corporations & Financial Services. See IFSA, 'IFSA Submission: Inquiry into Shareholder Engagement and Participation', 14 September 2007, available at
http://www.aph.gov.au/senate/committee/corporations_ctte/sharehold/submissions/sub16.pdf

information on institutional investors' voting instructions ahead of contested resolutions. This aspect of Chapter 6C appears to serve no broader interest that would benefit all shareholders.

- The original – and still important – purpose of Chapter 6C was to enable companies to obtain information about those who might be secretively building a significant shareholding interest in the company through interposed entities. The application of Chapter 6C to voting instructions extends the reach of the information required to be disclosed beyond this purpose and does not serve the original intent of Chapter 6C.
- RiskMetrics therefore recommends that Chapter 6C's extension to voting instructions be removed. RiskMetrics has no view on requiring the disclosure of proxy voting by institutional investors after the event. We note that, in the United States, registered management investment companies are required to disclose how they vote the proxies relating to the shares they hold in their portfolios.[27] We also note that some Australian fund managers and superannuation funds voluntarily disclose how they vote their portfolio shares.[28]
- **Securities lending:** The recent regulatory scrutiny of short selling worldwide has also focused attention on the principal means by which short selling is "funded", namely securities loans. However, apart from enabling hedge funds and other market participants to source shares for the purposes of short selling, securities loans enable the effective borrowing of voting rights free of the economic interest in the company that ordinarily accompanies voting rights.
- Under a securities loan, shares are "lent" temporarily to a borrower against the return of equivalent shares. This so-called loan involves the transfer of title to the shares being lent to the borrower but the economic incidents of the shares remain with the lender (as the borrower is required to pay to the lender amounts representing dividends and other distributions received on the shares during the term of the loan and, on termination of loan, the borrower is required to transfer equivalent shares to the lender at a pre-agreed price).
- As voting rights to shares pass with title, the borrower has the use of the votes attaching to the shares for the term of the loan. The lender retains no right to vote the shares during the term of the loan (although the standard form contract used in the Australian market, the Australian Master Securities Lending Agreement, provides for the borrower to vote the shares that have been lent to it in accordance with the lender's wishes; in practice, the only way in which a lender can be certain that the shares will be voted as desired is by terminating the loan and "recalling" equivalent shares from the borrower).
- This decoupling of voting rights from an economic interest in the company carries the potential for shares to be borrowed for the principal purpose of casting the votes attaching to the shares.[29] This can distort the results of shareholder voting, particularly in relation to controversial matters or other matters on which shareholder views are finely balanced. The voting result in that situation may not necessarily reflect the interests of the majority of shareholders that hold both title to and the economic incidents of shares. RiskMetrics considers it unlikely that securities would be borrowed in order to influence the outcome of a resolution directly related to remuneration. It is however possible that securities may be borrowed for voting purposes in situations that may have a significant influence on remuneration outcomes – such as a contested or controversial director election or a vote to approve a scheme of arrangement that would confer various benefits on executives and directors such as vesting of unvested equity incentives.

[27] US Securities and Exchange Commission, 'Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies', 14 April 2003. A proposal for Australian institutions to be required to make similar disclosures was defeated by the Commonwealth Parliament – after initially being approved by the Senate – in June 2004 as part of the CLERP 9 legislation. See Senate, *Hansard: 22 June 2004*, pages 24576-90.

[28] See, for example, http://www.unisuper.com.au/about-us/investment-governance/proxy-voting-record.

[29] H Hu and B Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions" (2008) 156 Uni Penn L Rev 625.

- Securities lending, when used to "borrow" shares, can also have an effect beyond the shares actually borrowed. Even if not voted, those shares are no longer available to the lender (unless recalled) nor do they form part of the free float of shares of the company. This has the potential to influence the outcome of a close contest by withdrawing votes from, for example, the opposition to a proposal recommended by the board. Moreover, where the borrowed shares are actually voted in favour of such a proposal, the impact on the opposition is effectively doubled (the votes are not available to them or their potential supporters, and have, instead, been effectively voted against them).
- RiskMetrics considers that the concerns raised by the decoupling of voting rights and economic incidents can be addressed by making securities lending activity more transparent (while the substantial shareholder disclosure provisions in Chapter 6C of the Corporations Act are capable of being triggered by securities loans, those provisions are not specifically directed at securities loans and do not address the concerns detailed above). We have closely followed the recent changes to the regulation of short selling in the Australian market and the proposals for reform that have been announced by the Treasury, the Reserve Bank of Australia and the Australian Securities Exchange, and we have strongly supported Treasury's proposal for the disclosure of all securities lending transactions.

Role of voluntary guidelines

The Issues Paper invites comment on whether or not there are international voluntary guidelines on remuneration practice that could be adopted in Australia, and whether Australia should adopt a code of practice on remuneration. As the Issues Paper notes, Australia already has several sets of guidelines on remuneration practices from groups as diverse as the Australian Shareholders Association, representing retail shareholders, to the Australian Institute of Company Directors. Such guidelines are useful to participants in the executive remuneration process as improving information flow, providing guidance on what is generally considered acceptable by certain groups and as a practical guide to setting remuneration levels. Given the diversity of listed companies it would not be appropriate to adopt a single code of practice on remuneration; as noted above, RiskMetrics considers the most appropriate way to ensure executive remuneration arrangements are acceptable to shareholders is to ensure shareholders are able to effectively oversee such arrangements.

Terms of reference 5: International developments

The Commission in its Issues Paper has also invited comment on international approaches to the issue of executive remuneration. RiskMetrics considers that international experience is valuable in reviewing Australia's executive remuneration framework, and in certain case is instructive. We have summarised the relevant international developments in the Appendix to our submission.

RiskMetrics does not consider that all of the recommendations produced by these reviews are applicable to Australia. In certain cases, such as the recommendation by the UK Treasury Committee that the remuneration of executives below board level should be disclosed (see appendix), the recommendation is not applicable to Australia as existing law already requires such disclosure. Many of the other recommendations from the various bodies noted above are common in many Australian companies, such as requirements for equity incentives to vest over three or more years and be subject to performance hurdles or requirements for companies to take into account non-financial criteria in determining performance pay. This indicates that in some respects Australian executive remuneration practice compares favourably with practices elsewhere, although this does not mean Australia's executive remuneration framework and practice cannot be improved.

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the issues raised in your Issues Paper.

Yours sincerely

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Appendix: International views on executive pay in the wake of the Global Financial Crisis

RiskMetrics recommends that the Commission should pay particular attention to the remuneration principles and guidelines being considered by the **United Kingdom Financial Services Authority** (FSA):

- While the FSA has stated that it has "no wish to become involved in setting remuneration levels",[30] the proposals released by the FSA in March 2009[31] address the principal concerns highlighted by the Commission in its Issues Paper. The FSA's principal concern – which is shared by the Commission – relates to the need to ensure that remuneration levels are aligned with effective risk management, and thus the risk appetite of the particular company, and the interests of long-term shareholders; and
- The FSA's proposals are directed towards participants in the financial services sector that it regulates. Nonetheless, these proposals are broadly applicable to all companies where there is a division between shareholders and management (as exemplified by the typical Australian listed public company with a dispersed shareholder base).

The FSA's proposals, as set out in its Draft Code on Remuneration Practices, are summarised below. These proposals are, in summary, designed to ensure that executive remuneration is consistent with effective risk management and that the interests of executives are aligned with the longer-term interests of shareholders:

- The remuneration committee of the board should be structured in a way that allows it to exercise independent judgment, and the committee, when setting the company's remuneration policies, should ensure that the policies are consistent with a reasonable assessment of the company's financial position, its risk profile and future prospects;
- The risk management and compliance departments or personnel of the company should have significant input into the setting of remuneration levels for other areas of the company's business. Equally, the remuneration levels for personnel in risk management and compliance should be set independently of the company's other business areas;
- Profit-based remuneration should be risk-adjusted, including for those risks not adequately captured by accounting profits;
- Remuneration levels should not be based solely on the results of the current financial year but should also take into account longer-term performance and future risks;
- Remuneration levels should take account of non-financial factors, including the executive's adherence to the company's risk management policies and the company's values as well as compliance with relevant regulatory requirements;
- Long term incentive plans should be risk-adjusted, in particular for longer term risk factors;
- Bonus policies should be sufficiently flexible to allow companies to elect not to pay a bonus in a year that the company makes a loss; and
- The majority of significant bonuses paid to executives should be deferred, in order to align the interests of the employee with the longer-term interests of the company. In addition, the deferred element should be adjusted to take account of the company's future performance.

The above proposals are premised on the FSA's view that executive remuneration structures at financial services companies contributed to the global financial crisis, by, in many cases, encouraging and rewarding excessive risk-taking and thus undermining effective risk management. In particular, the FSA has identified the use of performance metrics that were not risk-adjusted, such as earnings per share and total shareholder return, in determining levels of remuneration as creating powerful incentives for executives to engage in conduct designed to boost those metrics in

[30] FSA, "Remuneration Policies", *Dear CEO Letter*, 13 October 2008.
[31] FSA, "Reforming Remuneration Practices in Financial Services", Consultation Paper, March 2009.

the short-term (and thus boost their remuneration) but which was detrimental, in the longer-term, to the health of their companies.

The FSA's view on inappropriate executive remuneration structures is shared by other regulators as well as major financial sector participants, and the FSA's proposals in relation to remuneration policies are broadly consistent with similar proposals released by these bodies:

- The **European Commission** has stated that inappropriate remuneration practices in a large part of the financial services sector had run counter to effective and sound risk management, and had also induced excessive risk-taking and, consequently, contributed to the global financial crisis.[32] The Commission has recommended that companies in that sector should adopt remuneration policies which are consistent with effective risk management and do not entail excessive risk-taking, should cover all executives whose activities have a material impact on the risk profile of the company, and align the personal objectives of executives with the longer-term interests of the company. In particular, a company's remuneration policy should:
    - set maximum limits on bonuses;
    - bonuses should be capable of being withheld entirely or partly when performance criteria are not met;
    - a major part of the bonus should be deferred and the deferred element should take into account the risks associated with the performance to which the bonus relates;
    - termination payments should not reward failure;
    - performance metrics should take into account the overall performance of the company in addition to the performance of the executive and the executive's business unit;
    - performance should be assessed on a multi-year basis to take account of longer-term performance;
    - bonuses should be risk-adjusted; and
    - performance metrics should include non-financial criteria such as the executive's compliance with internal rules and procedures as well as standards governing the company's relationship with clients and investors.
- The **European Commission** has also released recommendations in relation to the remuneration of directors of listed companies.[33] These recommendations apply to both executive and non-executive directors. The European Commission states that the structure of directors' remuneration should be based on performance and also promote the long term sustainability of the company. In particular:
    - bonuses should be capable of being withheld entirely or partly when performance criteria are not met;
    - bonuses should be subject to pre-determined and measurable performance criteria;
    - performance metrics should promote the long term sustainability of the company and include non-financial criteria such as compliance with the company's internal rules and procedures;
    - a major part of the bonus should be deferred;

[32] Commission of the European Communities, "Commission Recommendation on Remuneration Policies in the Financial Services Sector", 30 April 2009.

[33] Commission of the European Communities, "Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the Regime for the Remuneration of Directors of Listed Companies", 30 April 2009.

- termination payments should not exceed a fixed amount or fixed number of years of annual remuneration. The European Commission recommends that a general limit of two years of the fixed component of remuneration should be adopted;
    - termination payments should not reward failure;
    - shares should not vest for at least three years after their award;
    - share options (and similar rights to acquire shares) should not be exercisable for at least three years after their award;
    - vesting of shares and share options should be subject to pre-determined and measurable performance criteria;
    - after vesting, directors should retain a stipulated fixed number of shares until the end of their term of office; and
    - remuneration of non-executive directors should not include share options.
- The **Committee of European Banking Supervisors** (CEBS) has recommended that financial institutions (and, again, the principles advanced are also applicable to listed public companies generally) adopt remuneration policies which are consistent with the risk tolerance and longer-term interests of the institutions and which discourage excessive risk taking.[34] In particular, it has recommended that:
    - performance metrics should take account of the performance of the executive's business unit and also overall company performance;
    - performance metrics should include financial as well as non-financial criteria, such as, in respect of the latter, compliance with the company's risk management policies;
    - bonuses should be adjusted for risk and cost of capital; and
    - significant bonuses should contain a deferred element linked to future performance.
- The **Financial Stability Forum** (FSF) has also observed that remuneration policies in the financial industry often rewarded and encouraged excessive risk-taking without regard to the longer-term interests of the company.[35] The FSF has recommended that companies align their remuneration incentives with longer-term company-wide profitability and prudent risk-taking, and, more particularly, its recently released principles on remuneration policies provide for:[36]
    - remuneration should be risk-adjusted, to take account of the risks imposed, but not yet realised, on the company by executives and their business units;
    - the bonus pool should be linked to the overall performance of the company, and executives' bonuses should be linked to their and their business unit's contribution to performance. In addition, the bonus should diminish or not be paid at all in the event of poor company, business unit or individual performance;
    - bonus payment schedules should take into account the varying time horizons over which risks are realised; and
    - the mix of cash, equity and other elements of an executive's compensation should align the executive's incentive to take risks with the risk appetite of the company.

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[34] CEBS, "High Level Principles for Remuneration Policies", 20 April 2009.
[35] FSF, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", 7 April 2008.
[36] FSF, "FSF Principles for Sound Compensation Practices", 2 April 2009.

- The **Senior Supervisors Group** has also highlighted the need to design remuneration policies that achieve an appropriate balance between:[37]
    - the company's risk appetite and its risk management policies;
    - short-term and longer-term company performance; and
    - individual business unit goals and company-wide goals.
- The **Counterparty Risk Management Policy Group** (CRMPG) (which comprises senior executives from major financial institutions) has acknowledged that flaws in incentive structures are likely to have led to conduct inconsistent with financial stability.[38] Accordingly, the CRMPG has recommended that incentives should be aligned with commercial success over the longer-term and discourage excessive risk-taking in the short-term. In particular, executive remuneration structures should be:
    - heavily based on the overall performance of the company; and
    - heavily equity-based, with this component of the remuneration vesting over an extended period of time, in recognition of the fact that short-term increases in profits and revenues can be offset or reversed in the longer-term.
- The **Institute of International Finance** (IIF) (which comprises senior executives from major financial institutions) has also acknowledged that inappropriate remuneration policies have contributed to the global financial crisis.[39] The IIF has recommended that incentives should be based on performance and be aligned with the long-term profitability of the company and should not induce risk-taking in excess of the company's risk appetite. In particular, executive remuneration structures should have the following characteristics:
    - remuneration levels should be based on the company's risk-adjusted and cost-of-capital-adjusted profitability;
    - remuneration policies should take into account the impact of the executive's business unit's returns on related business units and the company as a whole;
    - remuneration policies should take into account the company's overall results and the company's achievement of risk management and other goals; and
    - termination payments should take into account the executive's performance over time as well as the reason for the termination.

It will be seen from the above summary, that all of the bodies mentioned share the Commission's concern with the need to align executive remuneration with risk management and the longer-term interests of the company and its shareholders. In addition, the various proposals that have been released in relation to executive remuneration policies are broadly consistent with one another, in that they all recommend that executive remuneration should be risk-adjusted. Of these proposals, the proposals released by the FSA and European Commission are the most detailed.

It should also be noted that in none of the proposals is there any suggestion that the power of the board of directors of a company to set remuneration policies be curtailed to the extent of having a party external to the company – such as a regulator – involved in setting actual levels of remuneration. Nonetheless, the adoption of the risk-adjusted metrics recommended by the above bodies is likely to result in the curbing of remuneration levels (through the alignment of remuneration to the risk appetite of the company and the adjustment of the quantum of (variable component of) remuneration to take account of risks taken by the executive and their business unit.

[37] SSG, "Observations on Risk Management Practices during the Recent Market Turbulence", 6 March 2008.
[38] CRMPG, "Containing Systemic Risk: The Road to Reform", Report of CRMPG III, 6 August 2008.
[39] IIF, "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations", July 2008.

Finally, we wish to make mention of a report on the global financial crisis recently released by the UK Parliament.[40] The **Treasury Committee of the House of Commons** has taken the unusual step of criticising the FSA for being “extremely slow off the mark in recognising the risk that inappropriate remuneration practices within the banking sector could pose to financial stability”. The Treasury Committee has stated that:

- bonuses should be linked more closely to long term performance and the achievement of shareholder value;
- disclosure requirements in relation to executive remuneration should extend to senior managers at the sub-board level;
- a review of how institutional investors have voted in relation to companies’ remuneration reports should be undertaken;
- Remuneration committees have been “all to willing to sanction … the ratcheting up of remuneration levels for senior managers whilst setting relatively undemanding performance targets”;
- Remuneration committees should have a wider range of inputs, including from shareholders and employees, and should be less dependent on remuneration consultants; and
- The role of remuneration consultants in setting executive remuneration should be investigated, in particular in relation to potential conflicts of interest.

[40] House of Commons, Treasury Committee, “Banking Crisis: Reforming Corporate Governance and Pay in the City”, 12 May 2009.