AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
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Submission by

The Australian Institute of Company Directors

to

The Productivity Commission

in response to the

Issues Paper on “Regulation of Director and Executive Remuneration in Australia"

29 May 2009

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Introduction

The Australian Institute of Company Directors (AICD) welcomes the opportunity to provide feedback in response to the Productivity Commission's Issues Paper titled "Regulation of Director and Executive Remuneration in Australia".

AICD is the second largest member-based director association worldwide, with over 24,000 individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

AICD recognises the need, in light of current market and economic conditions, to review the framework governing executive and director remuneration arrangements. We note, however:

- some of the matters being examined by the Productivity Commission (hereafter “the Commission”) can be extremely complex (e.g. linking rewards to performance);
- some of the issues touched on extend far beyond the setting of remuneration, encompassing areas such as the merits of a free enterprise system, the role of boards, the role of corporations in society, the notion of "public interest" in business, the appropriate level of government intervention in business activities, etc; and
- the 45 day time frame provided by the Commission has not permitted in-depth responses to the 110 questions raised.

We would also like, at the outset, to draw the Commission’s attention to the Business Checklist for Commonwealth Regulatory Proposals[1], which has support from a number of leading associations, representing some diverse member interests. We believe this checklist should be followed if reform is being considered in relation to executive and/or non-executive director (NED) remuneration.

Notwithstanding the above comments, AICD has, to the extent it has been able to in the timeframe available, set out below its views on executive and NED remuneration as they relate to the current Review. The

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[1] http://www.companydirectors.com.au/NR/rdonlyres/F20F97AA-BC68-4779-B51D-A97F6C43D9C5/0/BusinessChecklistforCommonwealthRegulatoryProposals_1352007.pdf

submission is divided into two main parts. The first part sets out AICD's general comments. The second part includes responses to the specific questions posed by the Commission.

Some of the key points made in this submission are:

- the setting of executive remuneration is a complex exercise, often involving sensitivities and matters of judgment, and boards remain best placed to decide on appropriate remuneration arrangements;
- increases in executive remuneration levels in recent decades are understandable given market developments;
- larger Australian companies compete in a global market for executive talent;
- additional regulation of executive remuneration is not the answer and will only make matters worse;
- attempts at prescribing artificial remuneration limits or "straight jacketing" remuneration practices will have adverse consequences not only for the companies concerned but also general economic growth and our standard of living;
- executive remuneration levels and practices are going through a process of adjustment in many companies in light of changing market conditions and lessons learnt;
- care must be taken not to import overseas "solutions" for problems that are non-existent in Australia; and
- there is a disparity between risk and return for many NEDs (particularly not for profit entities) brought about by inappropriate director liability laws.

PART A: General Comments

A.1 The Performance of Australian Boards

In recent times there have been high profile instances where executive remuneration arrangements in some listed companies were criticised as excessive by shareholders, proxy advisors and/or media commentators. In some cases this criticism may have been justified; in other cases it is not.

Despite some comments made by others to the contrary, directors of Australian listed companies, by any international comparisons, have by and large done a good job at handling the inherent difficulties in executive remuneration. While there are exceptions to any general rule, Australian boards have generally acted responsibly, in the best interests of the company they serve and with the best of motives in the environment of the time.

We note that Australia's overall standard of corporate governance is well regarded internationally. For instance, in 2007 GovernanceMetrics International[2] ranked Australia first in the world out of 38 countries and well above other major centres in the Asia–Pacific region (GovernanceMetrics International Sept 2007). In 2008 Australia was ranked equal fourth in the world out of 39 countries (GovernanceMetrics International Sept 2008).[3]

To cite another example of the good standing of Australian corporate governance practices, findings from the world's largest survey on corporate boards found that Australian businesses are the best in the world at selecting board members.[4]

A.2 NED Remuneration versus Executive Remuneration

Not all executives are directors, and not all directors are executives. In essence, non-executive directors advise and oversee the activities of the CEO and other senior executives. Executive directors wear two hats: that of a company employee, usually a senior executive, and that of a board member. The responsibilities of directors at law do not differ between

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[2] See http://www.gmiratings.com/(ly4w4obitxhrvafloep3af55)/Default.aspx.
[3] Ranked ahead of Australia in 2008 were the United Kingdom, Canada and Ireland.
[4] See Andrew Kakabadse, 'Boards Walk the Talk' Business Review Weekly, 20-26 September 2007

executives and non-executives. Shareholders elect directors to the board and the board appoints the CEO and other senior executives.

While the Commission's Review covers both executive and NED remuneration, it should be remembered that NED remuneration has largely been less controversial compared to executive remuneration. There are a number of reasons for this:

- NED remuneration tends to be considerably less in quantum when compared with executive remuneration;
- NED remuneration often involves a simple fee structure, which is relatively straightforward; and
- any increase in available director "fee pools" of listed companies is subject to shareholder approval (i.e. a binding shareholder vote).

AICD is concerned, however, that there is upward pressure on NED fee levels, and that this is being driven by the multitude of inappropriate liability provisions that apply to directors. We have argued elsewhere that liability provisions should be made more uniform and more "principled" in nature[5]. By "principled" we mean laws based on Australia's concepts of natural justice, including laws which:

- have no reverse onus of proof;
- provide adequate defences (e.g. statutory business judgment rule) and appeals processes; and
- avoid strict and derivative liability on directors for actions within their corporations simply because of the position they hold rather than their knowledge or actions.

To the extent existing harsh liability provisions remain, we believe there will be an adverse impact on the supply of high calibre directors, which is likely to increase NED fee levels.

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[5] See, for example, "Towards Principles OH&S Laws", CEO's Report, Company Director Journal, October 2008, p8. Article located at - http://www.companydirectors.com.au/Media/Company+Director/2008/October/CEO+Report++Towards+principled+OHS+laws+Oct+08.htm.

A.3 The Importance of Australia's Largest Companies to the Economy

Where concerns have been expressed regarding the quantum of executive pay, these have tended to be directed at companies represented in our 100 largest listed companies.[6] Care must be taken not to look at pay issues in isolation. Our largest companies make a vital contribution to the performance of our economy and to the standard of living for many Australians. It is important to have appropriate people serving as CEOs and other senior executives in these companies, and to have appropriate remuneration structures to attract, retain and motive them. It should also be borne in mind that these executives are some of the elite of Australian business. Elite entertainers, sports people, professionals, entrepreneurs, etc tend to be highly paid the world over.

Figures showing the contribution of these companies to our economy and general standard of living are not easily compiled. In terms of information that is readily at hand, we draw the Commission's attention, by way of illustration, to the 2002 study "The Big End of Town and Australia's Trading Interests" published by the Department of Foreign Affairs and Trade. That study examined the contribution made by the "top 100" businesses in Australia (domestic and foreign), and suggested that those top 100 companies accounted for:

- around 20 per cent of the nation's total revenue;
- 11 per cent of the nation's employment;
- some 70 per cent of total ASX market capitalisation; and
- close to one-third of Australia's total exports of goods and services (2000/01).

The study also noted the contribution these companies made towards the nation's tax revenue, for shareholders and for the communities in which they are located.

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[6] John Egan of Egan Associates recently noted "The Australian setting in terms of executive pay excesses is significantly less profound than the US or many parts of Europe. While 9 out of 10 of Australia's top 50 company CEOs receive base remuneration of $1,000,000 or above, this ratio rapidly declines with 60% of the next 50 companies being so placed, less than 20% of the second 100 companies and around 5% of the second ranked 200 companies. Of the executive population in the top 50 companies, excluding the CEO there are less than 70 executives on base remuneration of more than $1,000,000, in the next 50 less than 10 and in the next 300 ranked companies (that is those ranked between 101 and 400) there are less than 10. If one assumes that across these 400 companies there are 4,000 executives stewarding businesses of varying scale the dimension of the challenge in relative terms is modest, albeit that press comment would reflect a somewhat more profound challenge." Refer to John Egan "Repricing Human Capital?" in Egan Associates Newsletter, April 2009. Newsletter located at - http://www.eganassociates.com.au/Portals/0/EAN02/newsletter02.pdf

A.4 Factors that Contributed to Growth in Executive Remuneration Levels

It is also important to consider the historical background to the many and varied types of remuneration arrangements we have today. It is particularly noteworthy that the level and form of arrangements have been influenced by a combination of events which occurred from the early 1990s:

- periods of strong growth;
- further globalisation;
- development of best practice standards;
- perverse outcomes of regulation, including from mandated disclosures;
- increases in the scale and complexity of some businesses; and
- competition for top executive talent.

These factors together helped spur the growth of executive remuneration in some companies. We discuss each of them in turn.

1. Periods of strong growth.

Over the past 15 years or so there have been periods of sustained sharemarket and economic growth. The periods 1995 to 2002 and 2003 (mid) to 2007 (late), saw substantial Australian market gains. A bull run of 77 months from 1995 to 2002 saw an Australian All Ordinaries cumulative market return of 90.7%, while another bull run from 2003 to 2007 over 56 months had a cumulative market return of 141.4% associated with it.[7]

Table 1 shows the growth in the number of ASX listed companies, domestic market capitalisation and the All Ordinaries Index.

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[7] Source "Bull and Bear Markets" presentation published by Advance Asset Management Limited. Available at http://www.advance.com.au/resources/afm/downloads/advisers/Bull_and_Bear(2).pdf

Table 1
Historical ASX Market Statistics – 5 Year Intervals

	Dec 1992	Dec 1997	June 2002	June 2005	June 2007
Number of listed domestic entities	1125	1159	1351	1570	1892
Domestic Market Capitalisation ($million)	$196,702	$453,941	$701,036	$959,979	$1,597,794
All Ordinaries Price Index	1549.9	2616.5	3163.3	4229.9	6310.6

Source: Compiled from information available on ASX's website (http://www.asx.com.au/research/market_info/historical_equity_data.htm) and ASX Fact File 2002

These bull markets coincided with strong underlying economic growth. Between 1994 and 2007 Australia averaged GDP growth in real terms of approximately 3.75% per annum, compared to an OECD country average growth rate of 2.6% per annum.[8]

2. Further globalisation.

During the same period (1994 to 2007) we also saw further globalisation occurring that was exhibited in a number of ways, including:

- local businesses expanding overseas;
- increased cross-border trades;
- increased mobility of capital;
- mergers and acquisitions by foreign companies; and
- increased labour mobility compared to previous decades[9].

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[8] Source: http://lysander.sourceoecd.org/pdf/factbook2009/302009011e-02-02-01.pdf

[9] "International Mobility Of Skilled Workers In APEC" , Proposal submitted for consideration by Canada, APEC, Economic Committee, Santiago, Chile, 28 – 29 February 2004. "There is a wide recognition that today's economy is being fundamentally transformed via globalization, economic integration, new technologies and a shift to more knowledge-intensive activities. An important aspect of this global knowledge-based economy (KBE) is the emergence of a new trend where a segment of the skilled labour force is becoming increasingly mobile……The new trend, which became more noticeable in the 1990's, is driven by the information technology revolution, the general economic integration of product markets (e.g. the increased globalization of corporations) and the premium paid for high-skilled workers. These globally mobile skilled individuals generally comprise those who participate in high-tech industries, manage multinational enterprises (MNEs), and occupy scientific and

The late 1990s and early 2000s, in particular, saw a number of international consolidations involving Australian companies.[10]

As businesses competed in the global market for executive talent (see below), or sought out improvements in remuneration practices as part of their competitive advantage strategy, some remuneration practices in existence overseas (most notably in the United States) began being adopted in Australia, and eventually became regarded as the norm. This has included the combined approach taken towards base salary, short-term incentives (often in the form of cash) and long-term incentives (often in the form of equity).

3. Development of best practice codes of corporate governance.

The early 1990s also saw increased focus on the corporate governance activities of listed companies. Overseas there were a number of important sets of best practice guidelines, including:

- the Cadbury Committee Code (UK, 1992);
- the King Committee Report (South Africa, 1994);
- the Toronto Report (Canada, 1994);
- the Greenbury Committee Report (United Kingdom, 1995); and
- the OECD Principles (1999).

In Australia we saw the introduction of several sets of guidelines – most notably the Bosch Committee Code (1991, 1993 and 1995) and the AIMA Blue Book (1995). In early 2003, the ASX Corporate Governance Council released its Corporate Governance Principles, Recommendations and Guidance.

A common recommendation or comment made in such codes was that a portion of executive remuneration should be tied to the performance of companies so as to align incentives of executives and shareholders[11]. This

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technical professions. These individuals participate in industries that are largely knowledge-based and global in scope."

[10] For example, BHP merger with Billiton (2001), Brambles merger with GKN (2001), Hanson takeover of Pioneer International (2000), Air New Zealand takeover of Ansett (2000) and Rothmans merger with BAT (1999). See http://www.dfat.gov.au/publications/the_big_end_of_town/the_big_end_of_town.pdf

[11] For example, The Greenbury Committee Report (1995, p17) said "The performance-related elements of remuneration should be designed to align the interests of [Executive] Directors and shareholders and to give [Executive] Directors keen incentives to perform at the highest levels". The ASX Corporate Governance Council (2003) said "Appropriately designed equity-based remuneration, including stock

concept was of course not new, but it began gaining more prominence as "best" practice.

4. Perverse outcomes of regulation.

Taxation limits in the United States spurring growth of equity incentives. The early 1990s in the United States saw sudden growth in incentive based elements of executive remuneration packages. This was partly as a consequence of a change to United States tax laws that limited the tax deductibility of base salary (see below). This change had an unintended "squeezing of a balloon" effect from base salary to other elements of executive remuneration packages – most notably, equity incentive arrangements. With continued boom conditions, the performance based elements of remuneration packages, including equity based elements, tended to grow – sometimes quite substantially.

Greater transparency leading to ratcheting up of packages. For reporting periods since 1 July 2004, Australian companies have been required to prepare a detailed remuneration report, relating to directors and the highest paid executives. This requirement was introduced in the belief that disclosure would provide a "check" on excessive remuneration being paid to directors and senior directors. While greater transparency is sometimes a sound regulatory principle[12], in the case of executive remuneration it has had the perverse effect of increasing remuneration levels. This has come about because the increased public comparability of remuneration levels[13] has provided CEOs and other executives (both incumbents and executive candidates), if they so choose, with a stronger basis on which to negotiate for remuneration levels that might not otherwise have been paid. The competition for executive talent and to be seen to be paying at least in the top 50 percent of extant remuneration packages (or say in the top 25) has had an inflationary effect. To put it another way, most companies do not want to be seen to be paying "average" or "below average" remuneration.

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options, can be an effective form of remuneration when linked to performance objectives or hurdles" (p55).

[12] "Sunlight is said to be the best disinfectant; electric light is the most efficient policeman": Louis Brandeis, "Other People's Money" (1914).

[13] Some comparative data was available before the introduction of remuneration reports through annual surveys and search firm databases, but the introduction of the remuneration report requirements made executive remuneration packages much easier to compare.

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5. Increase in scale and complexity of some businesses.

The periods of strong growth noted above led to an increase in size and complexity of some Australian businesses. Table 2 gives a sense of how our largest listed companies increased in value, in the space of approximately 15 years. The Table shows that from 31 December 1992 to August 2007 the aggregate market capitalisation for the largest 10 listed companies increased by more than 7 times.

Table 2
Market Capitalisation of 10 largest listed domestic companies

	31 Dec 1992	**31 Dec 1998**	**31 Dec 2003**	**Aug 2007**
Aggregate Market Cap	$75.6b	$237.8b	$312.6b	$544b
% of total Ordinary Capitalisation	43.4%	44.3%	40.2%	-

Source: Compiled mainly from ASX Fact Books. ASX Fact Books have not been prepared since 2006, hence the August 2007 figure is compiled from individual market capitalisation data that was available to us.

There is no doubt that the increase in scale and complexity of some businesses tended to make the roles of CEOs and directors in these organisations more demanding. So too has the media glare these companies and their executives often experience. Given these increasing demands it became more commonplace for larger companies to have global searches conducted in order to help identify suitable executive candidates.

6. Competition for top executive talent

A lot has been written about the need for Australian businesses to remain competitive on the world stage, and we consider that an important part of this is the ability of Australian companies to be able to compete successfully in the global market for executive talent.

A key factor influencing remuneration arrangements and levels in our larger listed companies is, and has been, global competition for executive talent[14], particularly in the financial services and the mining and resources sectors. As noted above, the increased demands on CEOs and other senior

[14] We note that the market for NEDs can also be a global one. AICD recently examined the profile for directors of top 200 ASX listed companies, and our analysis suggested that up to 15% of these directors are based overseas.

executives at top 50 listed companies, for example, are causing boards to look overseas to compile a suitable short list of candidates to consider for such appointments. Indeed, the nature of operations for some of our larger companies may well mean senior executives are located overseas. Similarly, boards are mindful of the risk to the business of senior executives potentially relocating overseas to secure other employment on more advantageous terms.

Attached to this submission are letters from Russell Reynolds Associates and Korn/Ferry International which provide support for the existence of a global market for executives and set out some evidence of how often global searches occur.

A.5 How Australia has Fared

As noted above, Australia is generally regarded as having a very high standard of corporate governance, including in the area of executive remuneration. We believe Australia is also characterised as having a good regulatory framework and a general culture of compliance.

The recent highly published remuneration practices in the United States, which contributed to the sub-prime crisis, have not been prevalent here. Neither did we see the "option back dating scandal" that occurred in the United States earlier this decade.[15]

We note that some basic characteristics of the Australian regulatory and business environment have not featured prominently in the United States:

- a majority (as opposed to a "plurality") voting system for the election of directors;
- a non-binding voting regime attached to annual remuneration reports;
- the separation of roles of Chairman and Chief Executive; and
- a prevalence of NEDs on boards of medium to large listed companies.

[15] See, for example, http://www.sec.gov/spotlight/optionsbackdating.htm.

A.6 Where we are Today

A dynamic environment

The position we find ourselves in today is:

- The market capitalisation of many companies has fallen, sometimes materially;
- The link made by some companies between the Company's relative rank and market capitalisation, and executive remuneration, may no longer hold true;
- Bonuses are clearly declining and many incentive plans are currently "under water" – such that there is little or no additional financial incentivisation beyond base salary in place;
- Current conditions may necessitate changes to company strategies, which may not be reflected in existing incentive arrangements.
- Accounting standards often over-value equity incentive elements of executive remuneration; and
- Arguably we are in the process of a paradigm shift:
    - we are starting to see shifts in what is considered to be good remuneration practice (e.g. less emphasis on short term incentives, holding securities post-retirement), though there is not necessarily a "single voice" on particular issues; and
    - some boards are reassessing their approach to remuneration structures and amounts.

Linking remuneration packages to performance can be a difficult exercise.

Linking remuneration packages to performance is not a precise science. There is no "silver bullet" or "one size that fits all".

A criticism directed at some boards, with the benefit of hindsight, has been that they have approved executive remuneration arrangements which are not "sufficiently" tied to appropriate "performance" outcomes. In some cases this criticism may be justified, however in the majority of cases AICD believes this misalignment is a reflection of the challenges involved with the setting of executive remuneration; particularly the long term incentive component.

AICD contends there should be greater recognition among policymakers and others that it is not a straightforward exercise to precisely align

"rewards" to "performance" for the many and varied possible sets of circumstances a company might face, particularly when economic conditions change radically and unexpectedly, as they have in recent times. The types of remuneration arrangements that companies enter into today are likely to be materially different to the types they would have entered into three years ago - and quite possibly, materially different to the ones they will be entering into three years from now if economic conditions have improved.

Many of the issues in executive remuneration today arise because of difficulties inherent in remuneration setting. We believe the way to address such issues is not through additional regulation but rather education and, depending on the circumstances of each company, a change in the way some boards (and others) approach remuneration issues. It was in this context that AICD recently issued some new guidelines on executive remuneration.[16] AICD is in the process of developing further guidelines and educational materials in this area, including in relation to the preparation of remuneration reports.

A.7 Going Forward

<u>Markets will adjust</u>

The present market conditions are likely to see a shakeout in executive remuneration:

- Executive remuneration levels at companies that have suffered large falls in market capitalisation are likely to adjust. Issues here include:
    - o how long a company's depressed market capitalisation is expected to continue; and
    - o existing remuneration arrangements are set out in legally binding contracts and it may take some time before they are changed by agreement or by effluxion of time.
- Changing market expectations around the relative importance placed on short-term versus long-term incentive arrangements are likely to see a change in remuneration structures.

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[16] Executive Remuneration: Guidelines for Listed Company Boards, February 2009.

- Some incentive plans which are currently "underwater" given the current market downturn will be changed in order to retain good staff in difficult times, and boards will need to give consideration to reducing unintended consequences of plans arising from an eventual improvement in economic and market conditions.

While it remains to be seen how quickly or to what degree remuneration levels will change for the bulk of large companies, we are already starting to see these adjustments occur. There are reported instances of changes in remuneration structures, and freezes or reductions in executive pay[17]. Where discrepancies remain, we are likely to see new arrangements put in place that are more in line with current conditions, as employment contracts come up for renewal or expire.[18] These issues are, however, still playing out and it will be some time before we see where they lead and what conclusions can be properly made. One thing is clear however; given the need to adapt to changed economic circumstances, there are some very interesting and difficult discussions occurring around executive remuneration in some boardrooms.

It should be noted that much of the current adverse commentary about executive remuneration is largely the result of current unfavourable economic conditions, particularly lowered share price levels and worsening employment prospects. There is no doubt that economic prosperity and periods of sustained market growth will return. This will also help to address some of the current concerns regarding "disparities" between executive pay and fallen shareholder returns.

Boards remain best placed to approve executive remuneration arrangements in their company's interests and as part of their competitive advantage.

The vast majority of boards are committed to putting in place remuneration arrangements that are in the best interests of the company they serve. While there have, with the benefit of hindsight, been some mistakes, these have often occurred due to a combination of changed economic circumstances and difficulties inherent in the prevailing paradigm for setting executive remuneration. As mentioned elsewhere in

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[17] We note, for example, recent actions in this regard by the Commonwealth Bank, AMP, ANZ and AXA Asia Pacific.

[18] We note in the last calendar year one third of CEO positions in top 100 companies have changed. Refer to John Egan, "Executive Remuneration: New Horizons, New Rules" in Egan Associates Newsletter, April 2009. Newsletter located at - http://www.eganassociates.com.au/Portals/0/EAN02/Executive_remuneration.pdf

this submission, AICD believes the way to address most of the current problems in executive remuneration setting is through further education and guidance. This is particularly the case for boards outside the top 100 companies that might only have to deal with a change in CEO every 5 to 10 years.

Negotiations regarding executive pay often involve sensitive information and matters of judgment. It is also one of the main bases boards have to align strategic and other business objectives with company performance. Boards remain best placed to make decisions in respect of the structure and appropriate levels of executive remuneration.

Boards are acutely aware that investors can usually choose to sell down their holdings, or not invest in the company in the first place, if there are inappropriate remuneration practices (with consequential adverse effects for the company). This is a real possibly given the wide range of investment opportunities (e.g. other equity investments, derivatives, futures, property, interest rate securities etc).

The existing Australian regulatory and market controls on remuneration are appropriate.

There is already a considerable amount of regulation governing executive and NED remuneration, including:

- a reasonable benefits test[19]:
- statutory limits on termination payments[20] (in the process of being tightened[21]);
- extensive disclosure rules including the annual remuneration report[22] and continuous disclosure obligations[23];
- an advisory shareholder vote on the annual remuneration report[24];
- listing rule requirements[25]; and
- a general legal duty of directors to act in a company's best interests[26].

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[19] Corporations Act, sections 208(1) & 211(1).
[20] Corporations Act, Division 2, Part 2B.2.
[21] Refer to Federal Treasury, "Exposure Draft: Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009", Issued 5 May 2009.
[22] Corporations Act, section 300A. Introduced in 2004.
[23] Corporations Act, Chapter 6CA and ASX listing rule 3.1.
[24] Corporations Act, section 250R(2). Introduced in 2004.
[25] Including shareholder approval requirements, limits on termination payments and an "if not why not" reporting regime.
[26] Corporations Act, sections 180 and 181.

In addition, there is active external scrutiny of remuneration packages including considerable media interest in packages considered excessive. Boards that approve what may be considered "excessive" remuneration packages do so at their own peril. Remuneration strategies like other business strategies are a vital part of the competitive dynamic between companies. It can be seen now, that in the downturn, those companies that have difficulties with their remuneration structures are suffering a competitive disadvantage, if only in terms of the time boards and executives spend trying to convince the market and other stakeholders of their beliefs, and the effect on share prices, capital and debt raisings, etc.

Heavy-handed regulation of executive remuneration is not the way forward.

Attempts by legislators overseas to try artificially limit executive remuneration have been ill-advised and of marginal utility.

- In 1984, the US Congress passed a law eliminating the tax deductibility of golden parachutes that exceeded three times base salary. A level just under this became the norm.
- In 1993, the US Congress said only $1 million of an executive's salary would be tax deductible. There was “squeezing of the balloon” effect from base salary to short term incentives and long term incentives.

Similarly, we believe attempts to specify particular forms of “best practice” would be counterproductive:

- there is no “one size fits all”;
- such attempts may well stifle further development of remuneration practices and/or restrain future company growth; and
- such an approach would be at odds with the approach taken to other corporate governance issues, including the current “if not, why not” approach contained in the ASX listing rules.

A.8 A Note on Termination Payments

AICD has responded to Federal Treasury's invitation to comment on the "Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009" (hereafter "the draft Bill"). We have outlined our concerns about the likely intended and unintended consequences of the

draft Bill, the lack of consultation prior to the Bill being prepared, and the lack of regulatory impact analysis. In summary we are of the opinion that-

- the draft Bill puts Australian companies at a market disadvantage compared to other major countries such as the United States, the United Kingdom and those in the European Community;

- the draft Bill is likely to cause distortions in the structure of executive remuneration (e.g. a "squeezing of the balloon" effect);

- the proposed shareholder approval threshold is too severe and should be changed from one year base pay to two years total remuneration. Alternatively, whilst not our preferred alternative, in order to take account of the legitimate practice of providing for higher potential termination benefits in the early years of an executive contract, the threshold could be 2 years total remuneration within the first 2 years of a contract, after which time the threshold level could step down to say one year base salary over time (e.g. a further year);

- the proposed changes should apply only to publicly listed companies;

- companies should have the ability to seek shareholder approval of executive termination payments in advance, and if they choose to seek approval after contract termination, this should be at the discretion of the board which is the current practice and not have to wait until the next annual general meeting (AGM);

- the draft Bill should be referred to the Productivity Commission so that it can be looked at in conjunction with other aspects of executive remuneration; and

- there should be a sunset provision contained in the new legislation, as opposed to merely a stated intention to review the law.

A copy of our submission to Federal Treasury is attached.

We submit that the Productivity Commission should examine the issue of termination payments, including the likely consequences of the draft Bill, as part of its review of Executive and NED remuneration.

PART B: RESPONSES TO SPECIFIC QUESTIONS RAISED

B.1 Definitions and scope

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

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

The appropriateness of definitions for "remuneration" and "executive" depends very much on the purpose to which they are put. For the purposes of the Commission's review we consider it sufficient to regard remuneration, in general terms, as encompassing annual base salary, short term incentives, long-term incentives, termination and post-employment payments and other benefits (e.g. value of non-recourse loans, special retention payments, etc).

We note there are some practical interpretation issues with the current definition of "key management personnel" in connection with remuneration reports – relating to identification of "key management personnel" and when this identification should be made. However, we consider these are matters of fine-tuning and the definition's coverage is otherwise appropriate for the purpose of preparing a remuneration report, and for the general purpose of the Commission's Review.

How should 'corporate performance' and 'individual performance' be defined? Is it possible to define them in general terms that are applicable across most businesses?

Again, the appropriateness of the definitions of "corporate performance" and "individual performance" will depend on the purpose to which they are put. Assessments of performance are typically made in the context of corporate, divisional or role specific goals against the industry and economic backdrop of the time. Performance objectives and measures will often vary from company to company and individual to individual, depending for example on the strategic objectives of the company and the role an individual performs in a company.

Performance measures chosen will have financial and/or non-financial aspects. They will also have absolute and/or relative aspects. There may also be risk considerations.

It is not possible to define "corporate performance" or "individual performance" in a general way that is suitable for all purposes or for black letter law. There is no "one size fits all" or even "one size fits most".

Or is transparency in performance hurdles for incentive payments the more important issue?

AICD believes transparency of performance hurdles is far more preferable than requirements specifying or restricting hurdle choice. We would qualify this by saying, however, that contemporaneous disclosure of performance hurdles may not always be in a company's best interests because of competitive advantage issues. We note that forcing contemporaneous disclosure in the latter cases may well result in sub-optimal performance indicators being adopted, in order to limit the commercial detriment to the company associated with publicly disclosing information of strategic value to competitors.

To what extent do external performance indicators 'net out' underlying market growth factors from entrepreneurial and managerial performance?

While remuneration plan design has become reasonably sophisticated, it is not without its complications. On the one hand, absolute performance measures may mean executives are more likely to be rewarded for events beyond their control (such as improved corporate performance that flows from a general economic upturn), while on the other hand, relative performance measures (most commonly referenced to a peer group) may result in executives still receiving high bonuses when shareholders' absolute returns have fallen (such as when there is a market downturn). In practice it is not uncommon to see a combination of both types of measures, which reflects attempts to minimize drawbacks associated with using only one or several types of measurements. This is a very complicated area.

B.2 TOR 1: Trends in remuneration

Consider trends in remuneration in Australia, and internationally, including, among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long-term and equity based payments and termination benefits and the relationship between remuneration packages and corporate performance.

How are levels of director and executive remuneration determined?

Generally speaking, executive remuneration levels are determined through a process of negotiation, and typically by reference to a range of factors. The process may well vary from company to company but often involves the company taking external advice. Competitive influences, which may be domestic or global, will have an impact on remuneration levels, both reflecting the broader marketplace, possibly a shortage of talent and sometimes the particular circumstances of the company.

Senior executives are often "related parties" of the company, as defined in the Act, and as such their remuneration must be "reasonable"[27]. There is no guidance provided in the Act as to what is "reasonable" and little by way of precedent in Australian case law. The Act, makes it clear that reasonableness is to be tested by two objective factors, namely the circumstances of the company and of the related party. The company's circumstances could require consideration of such factors as the:

- nature, scale (market capitalisation, total assets, revenue, employee numbers, and so on), and profitability of the company;
- industries and markets in which it operates;
- operating locations, including whether it is an international company;
- structure and responsibilities of the board;
- future prospects of the company; and
- risks, challenges, complexity and diversity of its business.

A company's circumstances may be considered by reviewing comparative data for companies with similar operating characteristics. Similarly, consideration of an executive's circumstances may encompass

[27] Corporations Act, sections 208(1) & 211(1).

reviewing comparative data for other executives in similar roles and of equivalent calibre, including skills, experience and qualifications. Factors to consider may include:

- the executive's qualifications;
- the prevailing economic conditions;
- the range of remuneration for comparable roles in the same industry;
- the remuneration structure of the company (for example, intra-company relativities);
- the data for other CEOs;
- the formality and timing of the decision of the board concerning remuneration;
- the executive's responsibility for the company's inception and/or success;
- remuneration paid to an executive in previous years; and
- remuneration paid to the CEO's direct reports.

NED remuneration is determined by the board, typically after taking external advice. Again, remuneration must be "reasonable". The aggregate amount of directors fees for listed companies is paid out of an annual "fee pool". Any increases to this pool must be approved by shareholders.

Remuneration levels for NEDs often take account of factors such as:

- the company's existing remuneration policies;
- the size and complexity of the company's operations, for example, the nature and variety of its businesses, geographic locations, national and international diversity, technology used;
- the time needed for the task;
- the number and extent of board and related sub-committee meetings;
- the risks inherent in the directorship;
- qualifications and experience of the individual concerned; and
- industry comparisons.

The chairman of a board is usually remunerated at a level that is a multiple of other directors' remuneration[28], to acknowledge an additional

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[28] For larger companies this is often double, sometimes higher. For smaller companies the differential may be as low as say 25%.

workload. Chairmen and members of Board Committees often earn additional amounts, again because of additional workloads.

AICD has issued guidelines for NED Remuneration, which are available on its website (also attached).[29]

We note the Commission's reference to the academic literature on page 10 of its Issues Paper in the context remuneration drivers. We caution the Commission in its review of extant academic writings. Much of the commentary and analysis is directed at the United States environment, which we note elsewhere in the submission has some significant differences to the Australian environment, including in relation to regulatory framework and prevailing corporate governance practices.

What constraints exist, and what is the market's role in determining remuneration levels?

There are some important constraints on companies when determining executive and NED remuneration. First, there are a number of instances where approval of shareholders is required, including:

- an increase in available director fee pool (listing rule 10.17);
- approval of securities issued to directors and their associates under an employee incentive plan (listing rule 10.14); and
- approval of executive termination payments in certain instances (e.g. ASX listing rules 10.18 and 10.19, and sections 200B and 200C of the Corporation Act).

Other legal constraints include:

- remuneration paid to related parties must be "reasonable" (see above); and
- directors have fiduciary duties to act in the best interests of the company they serve.

The level and form of executive remuneration packages decided upon is also influenced or constrained by the company's working capital position. For example, a greater emphasis on equity-based arrangements (e.g. options) as opposed to cash is often evident for smaller companies, particularly start-ups. It is important to recognise that there are

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[29] http://www.companydirectors.com.au/NR/rdonlyres/DADE887E-23C6-4FDD-BB84-019267BD3DE8/0/AICDPositionPaperno12NEDRemuneration.pdf

approximately 2000 ASX listed companies and the vast majority of these are SMEs.

Potential adverse shareholder reaction is also likely to occur where remuneration is seen to be excessive. The trigger for any such adverse reaction is usually the remuneration report prepared by the company or the non-binding shareholder voting process that ensues. It is further evident that "excessive" remuneration payments are likely to result in adverse media comment attracting potentially adverse commentary on the company, its reputation and the board members themselves.

The market for executive talent is paramount in this area and like markets everywhere it sometimes overshoots or undershoots in booms and busts. For large publicly listed companies the market for say CEOs, direct reports and some specialist positions is often an international or global market. For smaller companies the market may be more local.

What are the major drivers of negotiated outcomes? Have they changed over time?

Negotiated outcomes are likely to be driven largely by factors such as the demands of the executive role, the attributes the candidate possesses that relate to the role, and market conditions for executive services.

The demands on executives are likely to vary from company to company. It could be, for example, an executive is brought into a company to effect fundamental change (including a major cultural change). Company size and complexity are also likely to be relevant factors.

Similarly, demands on directors can vary from company to company. The liability of directors under a multitude of laws has had the effect of decreasing the willingness of some directors to take on further board positions (see above). Director liability has been said to be "out of proportion with pay"[30].

It is our contention that the demands on senior executives and NEDs of larger companies have increased substantially in recent years. This has been driven by a range of factors including:

- Increase in the size and complexity of business;
- Increase in compliance requirements;

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[30] Refer, for example, ProNed, Non-Executive Directors' Survey 2009, p12.

- Greater public scrutiny; and
- Greater stakeholder engagement on various issues.

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

There are various annual surveys (see below) that can be used to assess growth in the level of director and executive remuneration in recent decades. What will be apparent is that not only have aggregate levels increased, so has the proportion of remuneration packages that represent performance-based pay (see above).

Part A of this submission discussed factors that contributed to increases in executive remuneration. In summary, these factors were:

- periods of strong growth;
- further globalisation;
- development of best practice standards;
- perverse outcomes of regulation;
- increase in scale and complexity of some businesses; and
- competition for top executive talent.

Some sectors and segments have been impacted more than others. In particular, competitive pressures in the banking and finance sector have seen some relatively large increases. Large multinational corporations that compete in the global market place for executive talent have also been impacted disproportionately when compared to other "more locally" based industries and companies.

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?

As noted earlier in this submission, NEDs are often paid in the form of fixed fees, while in recent decades executives have tended to have packages involving a base salary, a short term incentive and a long term incentive. The short term incentive element is often in the form of cash,

while the long term incentive element is typically in the form of equity entitlements.

It is common for companies to have bonus arrangements for other employees, based on Key Performance Indicators (KPIs). There are many possible sets of arrangements, though short term cash incentive payments have been reasonably commonplace. Some companies also have employee share plans. We note AICD has been supportive of the Federal Government doing more to increase the attractiveness of company wide employee share schemes through additional tax and regulatory relief.[31]

Remuneration differences within a company typically reflect assigned responsibilities, and differing market rates for individuals with particular experience or qualifications necessary for a role. Incentive arrangements, in particular, usually reflect the capacity of individuals to influence the desired performance of the company.

While it is difficult to generalise, we believe it is fair to say that some pay discrepancies can serve to motivate employees with promotional aspirations. Of course big pay discrepancies may possibly also serve to demotivate individuals, and companies in Australia are acutely aware of this. Again, disclosure in remuneration reports has not helped this situation.

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

AICD does not seek to justify particular instances of executive remuneration. We also think it is dangerous for others to do this. The markets have generally dictated where remuneration is likely to rise or fall. For example, if a CEO works for a very large listed public company in a boom period it is likely that the CEO will be paid relatively highly. The reverse is likely to be true in depressed times, particularly when the total remuneration package including incentives, etc is taken into account. AICD would argue there is no normative yardstick.

As noted above, remuneration levels are influenced not only by market forces of demand and supply, but also a range of factors which relate to the company's circumstances and the individual's circumstances. There is no simple "one size fits all" test.

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[31] We refer the Commission to work undertaken by the Australian Employee Ownership Association (AEOA) - http://www.aeoa.org.au/0024/default.asp

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It is clear that some boards, with the benefit of hindsight, have made mistakes – remembering that the setting of executive remuneration can be an extremely difficult exercise. In other cases, relatively high levels of executive pay may be more the product of market forces. There will inevitability be exceptions, but as a general rule we consider executive remuneration levels are appropriate when compared to remuneration levels and practices in other developed nations[32].

NED remuneration levels are typically less contentious, and the available pool of fees for listed companies is approved by shareholders (see above).

We do not believe it is the Productivity Commission's role to be assessing whether executive and NED remuneration levels are "justified", particularly in the absence of any evidence of market failure or widespread abuse. We also do not see the benefit in the Commission following this line of questioning as it would then have to compare executive pay with the remuneration of say sports people, entertainers, professionals, etc.

Notwithstanding this, we consider executive and NED remuneration is "justified" if it is "reasonable" in the company's and the individual's circumstances. We outlined above some of the factors that go to this determination by boards.

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 performance is a complex area that is likely to vary from company to company. No doubt the Commission will be provided with instances of both good and bad

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[32] Refer, for example, to comments made by Michael Robinson, Executive Director, Guerdons Associates on the SBS Insight Programme, 7 April 2009 - "On a global basis, yes [Australian shareholders are getting value for money from their CEOs]. You look at our CEOs or executive pay in general relative to other countries- it's certainly lower than the United States. The US chief executive would be paid two to three times an Australian chief executive for managing the same-size company. In the UK, it would be 20%, [more] depending on the kind of industry you were in, sometimes 30% more - France, about 15% more. And so on. It's not bad on a global scale. There aren't many other countries with as good a value for money, I think - maybe Japan, obviously, is a good example, and Sweden might be another one, but very few others." Excerpt of programme transcript taken from - http://news.sbs.com.au/insight/episode/index/id/60#transcript

perceived linkages between company performance and executive pay, however there is in AICD's view a level of remuneration which must be paid to attract the best executives and directors. Indeed, there is a "market rate" in this regard, especially if a company is trying to attract international executives and non-executive board members,

As noted elsewhere in this submission, in order to reinforce independence, directors are often paid in the form of fixed fees, which are not tied to performance. Performance issues are, however, something that may go to whether a director is re-elected, or appointed to other boards.

It needs to be remembered that directorships of listed companies in aggregate account for less than 5 percent of total directorships. Many individuals choose to serve as company directors for no or little pay, particularly in the not-for-profit sector. Similarly there are many executives who take on roles that are afforded less remuneration than they have might otherwise earned in the for-profit sector.

Remuneration levels over time reflect “risks” inherent in roles. In the case of NEDs we note that this “risk-return” relationship is such that there is upward pressure on NED fees. This issue is particularly acute for directors of listed companies. We note Federal Treasury undertook a survey[33] of top 200 listed company directors in conjunction with the AICD to assess the impact of corporate laws that impose personal liability on directors:

- 78 per cent of respondents considered that there was a medium to high risk of being held personally liable for decisions they or their boards had made in good faith;
- 78 per cent believed that the risk of personal liability had caused them, or the board on which they sat, to occasionally or frequently take an overly cautious approach to business decision-making; and
- 64 per cent suggested that such an approach had inhibited an optimal business decision to a medium to high degree.

Directors strongly highlighted derivative liability laws, such as those for occupational health and safety and environmental protection, as reasons for their overly cautious approach to decision-making. The duty to prevent insolvent trading and continuous disclosure laws were next in order for tempering decision-making. These findings reinforce the

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[33] Refer to Senator the Hon Nick Sherry, Press Release, "Minister Welcomes COAG Decision on Directors' Liabilities", 18 December 2008. Survey results are available at http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1387

anecdotal evidence that a heavier than necessary director liability regime, is promoting sub-optimal decisions for the economic advancement of the companies and their shareholders, which will have resultant effects on tax revenue, etc.

In making their assessment, respondents commented on the imbalance in the risk/reward trade-off for directors, increased regulation and that board decisions made in real time are often judged in litigation with the benefit of 20/20 hindsight and with few time limits.

In the context of executive remuneration, we note that if there is a major discrepancy between remuneration levels in Australia and abroad, we are likely to see executive talent move or stay off-shore, or move to other types of employment. It will also mean it will be more difficult for companies to attract executives from overseas.

It is sometimes commented that executives should "earn less" in difficult times, when a company's absolute performance is down. Ironically, this is when companies may well be asking more of executives, particularly where a business is running into financial difficulties. It seems somewhat paradoxical to us that shareholders are happy for executives to share in rewards during boom times, but are often not prepared to reward executive efforts when companies are experiencing particularly difficult periods, through no fault of the company, the board or the executives concerned.

What are the key drivers of performance for directors and executives?

There are many possible drivers of individual performance. Key drivers may well vary from individual to individual. Remuneration is one possible driver. As might be professionalism, the desire to be successful, to be at the top of one's field, career building, social contribution, service, or to effect substantive change and make a difference. In the case of not-for-profit sector a key driver for a NED might be community service. We suggest it is often the case that remuneration will need to be considered adequate but once that criterion is satisfied, one or more of these other factors will take over.

We note reputation can be a major driver of performance for NEDs. Loss of reputation is likely to impact materially on the capacity to maintain a board position(s) or secure others. This can also be of particular concern towards the end of directors' working careers.

Are there factors other than remuneration that influence their performance?

While remuneration can be a powerful driver/motivator, performance is of course not always driven or influenced by remuneration. For instance, as mentioned above, there are many NEDs in the not-for-profit sector that work for no or comparatively little money.

What changes have taken place in the type and structure of remuneration over recent decades? What has driven these changes?

Below is a typical snapshot of CEO remuneration at different points in time:

- 1970 – base pay, sometimes with a relatively small discretionary cash bonus
- 1980 – still predominantly base pay, often with a larger discretionary cash bonus than previously
- 1990 – fixed salary (82%), sti (5%), lti (13%)*
- 1995 – fixed salary (62%), sti (10%), lti (28%)*
- 2000 – fixed salary (52%), sti (16%), lti (32%)*
- 2004 – fixed salary (40%), sti (21%), lti (39%)*

* Source: J Shields "Managing Employee Performance and Reward" (2007)

Part A of this paper discussed some of the major drivers for these changes, including –

- periods of strong growth;
- further globalisation;
- development of best practice standards;
- perverse outcomes of regulation;
- increase in scale and complexity of some businesses; and
- competition for top executive talent.

Current indications are that going forward there is likely to be less emphasis on short term incentive components subject to variables such as tax treatment of shares, etc.

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)?

It is difficult to assess the degree to which executive or NED remuneration arrangements may be promoting inappropriate risk-taking or other forms of behaviour inconsistent with the best interests of companies. In the case of NEDs receiving fixed fees (who may or may not fee sacrifice to obtain company shares), we do not believe this form of remuneration of itself is driving inappropriate actions. We have noted above the risk/return disparity inherent in serving as a NED which is caused largely by inappropriate director liability laws. These laws have the potential effect of promoting overly risk adverse actions.

In relation to executives, our wide ranging discussions with the director community lead us to believe there is no widespread or systemic issue of inappropriate risk-taking or problem behaviour occurring. This is an issue boards consider when setting executive remuneration.

We note that both the G20 and the Financial Stability Forum have identified remuneration practices as a contributing factor to the global financial crisis, and that in the Australian context APRA is currently considering its regulatory approach towards remuneration arrangements of APRA-regulated entities.[34]

Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?

Boards should make the assessment of the appropriate level of risk taking and this should be consistent with the company's objectives, as communicated to shareholders. Boards should also be responsible for setting appropriate strategic objectives for the company, which again should be communicated to shareholders bearing in mind issues of competitive advantage.

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

The answer to the question depends very much on what is meant by the term "public interest". This is typically a vague concept.

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[34] See APRA Media Release "APRA outlines approach on executive remuneration", 9 December 2008 and APRA, Discussion Paper, Remuneration: Proposed extensions to governance requirements for APRA-regulated institutions, 28 May 2009. Available at http://www.apra.gov.au/Policy/Remuneration-requirements-consultation-May-2009.cfm.

We believe that generally speaking the setting of executive remuneration should remain a matter for the company; it is not a matter that requires Government intervention on the grounds of "public interest". Indeed, it is in the "public interest" for businesses to grow and prosper, and this is more likely to occur when boards have sufficient flexibility to tailor remuneration arrangements that are appropriate in a company's circumstances to attract, retain and incentivise key executives.

We consider there may be grounds for regulatory intervention where there has been systemic failure in the setting of remuneration (there has been no such systemic failure in Australia), or, in the absence of intervention, there are potentially significant externalities flowing from remuneration decisions that impact on the public at large (such as we saw in the United States with the sub-prime mortgage market).

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

Most companies seek to put in place remuneration arrangements where a portion of an executive's remuneration is linked to performance metrics. The key drivers of performance, and the choice of performance metrics, may well vary from role to role and from company to company. There are often financial and non-financial aspects to performance, as well as short and longer term aspects.

Shareholder associations have tended to express a preference for CEO performance-based pay to be tied directly (in total or in substantial part) to relative Total Shareholder Return (TSR). Our view is that relative TSR can be problematic:

- it tends to be a narrow measure of performance;
- it assumes that a suitable "peer group" of companies can be defined, which can be challenging in a relatively small market such as ours. If there are a relatively small number of companies dominating an industry, this inevitably leads to size-based comparisons, where there may be little comparability in terms of the challenges CEOs face; and
- it is now proving unsatisfactory to some shareholders who have issues with an executive receiving a significant bonus in light of current market conditions, notwithstanding the executive may have performed extremely well when compared to peers.

NEDs tend to be paid a fixed fee, which is set higher where they have additional roles (e.g. chairman, board committee chairman or member). In medium to large listed companies it is generally considered inappropriate for NEDs to participate in incentive-based schemes. It is often encouraged though, that NEDs sacrifice a portion of their fees to purchase shares in the company they serve. Some companies, typically smaller listed companies, remunerate NEDs in the form of options or the like. This often reflects funding constraints, a reluctance to add to the fixed cost base of the company or the "risk-return" profile of the company concerned.

Are there other useful data sources on director and executive remuneration over time in addition to those noted above?

There is no shortage of published remuneration reviews. Some examples are listed below.

Non-Executive Director Remuneration:

- ProNed, "Non-Executive Directors' Survey Report";
- Korn/Ferry International and Egan Associates, "Board of Directors Study in Australia and New Zealand";
- Godfrey Remuneration Group and Spencer Stuart, "Top 200 Board Remuneration Report"; and
- Connect 4 Boardroom Remuneration Review.

Executive Remuneration:

- Korn/Ferry International and Egan Associates, "Board of Directors Study in Australia and New Zealand" (includes CEO remuneration);
- Mercer, "Top Management Remuneration Report";
- Godfrey Remuneration Group "Top Executive Remuneration Review"; and
- Connect 4 Boardroom Remuneration Review.

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B.3 TOR 2: Effectiveness of regulatory arrangements

Consider the effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices in Australia including:
- ***the role, structure and content of remuneration disclosure and reporting***
- ***the scope of who should be the subject of remuneration disclosure, reporting and approval***
- ***the role of boards and board committees in developing and approving remuneration packages***
- ***the role of executives in considering and approving remuneration packages***
- ***the role of other stakeholders, including shareholders, in the remuneration process***
- ***the role of, and regulatory regime governing, termination benefits***
- ***the role of, and regulatory regime governing, remuneration consultants, including any possible conflicts of interest***
- ***the issue of non-recourse loans used as part of executive remuneration and***
- ***the role of non-regulatory industry guidelines and codes of practice.***

Boards, on behalf of shareholders, oversee management of the company with a view to enhancing corporate performance. To this end, remuneration is a key tool in attracting and motivating management. If boards' ability to set executive remuneration is removed or materially hampered, not only will their ability to attract an appropriate CEO and senior executive team be hindered; their on-going influence over management will also be considerably weakened.

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?

AICD considers:

- there should be greater recognition given to the complexities and difficulties involved with the setting of executive remuneration;

- the emphasis should be on further education, not only of directors, but also other stakeholders; and

- further regulation in this area is not required and will more than likely be counter-productive.

Deferral of rewards

We believe there would also be merit in examining the relevant parts of the Income Tax Assessment Act (ITAA) that relate to termination benefits. In particular, whether tax liability in respect of unvested equity securities under employee share schemes should continue to be triggered on cessation of employment (see Division 13A of the ITAA)[35]. This is particularly relevant in the context of the intent of the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009*, as the existing ITAA provisions work to promote accelerated payments on termination, thereby putting upward pressure on lump sum payments. These ITAA provisions also work against other initiatives (e.g. industry led, current APRA deliberations, etc) that seek to encourage long-term executive incentive plans continuing post-employment.

Termination Benefits

As noted in our submission to Treasury on the draft Bill, we believe the following matters should be closely examined:

- the length and complexity of sections 200A to 200J;

- how these provisions relate to non-cash benefits (e.g. equity based incentives, insurance benefits, etc);

- the use of the term "payment" in section 200G and whether this is too narrow (e.g. if someone is going to a receive pro rata vesting of shares or options for past services rendered on termination the benefit will prima facie not come within this exception because it is not a "payment" and so approval may be required);

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[35] We note separate consideration is being given to whether existing taxation concessions made in relation to employee share schemes should continue. See, for example, http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/055.htm&pageID=003&min=ceb&Year=&DocType=.

- clarification of the meaning of "past services" in section 200G(1); and

- the appropriateness of the strict liability offence set out in section 200D(2), particularly when ambiguity regarding both the definition of termination benefits and the approval requirements remains (see above).

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?

AICD believes on the whole the existing arrangements governing NED and executive remuneration are effective in promoting companies putting in place appropriate remuneration arrangements.

We do not consider there should be further mandated disclosure. We say this on the basis that existing requirements result in sufficient transparency and accountability. In particular, we note public companies are required under the Corporations Act to prepare annual remuneration reports, and are subject to continuous disclosure requirements. In addition, the ASX Corporate Governance Council's Guidelines set out additional information that companies should prima facie provide.

We do consider there is room for further some guidance, particularly in relation to the preparation of annual remuneration (e.g. a clear statement as to the rationale for remuneration structures), and AICD intends to provide this (see below).

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?

Yes, we consider current disclosures in the remuneration report, driven by reporting requirements, are often too complex for the average reader.

Yes, we believe the coverage of executives in the remuneration report is appropriate.

AICD does not believe any further disclosures should be required. We also caution that care needs to be taken in providing simple consolidated figures. Total remuneration figures included in remuneration reports are often interpreted by others (media commentators, some shareholders, member of the public, etc) to be "take home" pay – which they are not. The discrepancy between reported and take home pay is mainly because of the prescribed accounting treatment for long term incentives. It is already a challenge for boards to distinguish between take home and reported remuneration, and further prescription of consolidated remuneration will only compound this problem.

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?

We believe detailed remuneration matters are better dealt with by voluntary guidelines than by detailed legislative requirements. Guidelines assist boards and others to readily ascertain what is considered to be good practice, while at the same time allowing flexibility should a company's circumstances warrant a different approach.

AICD has issued a range of publications on NED and executive remuneration, including:

- Executive Remuneration: Guidelines for Listed Company Boards, February 2009;
- Executive Termination Payments, Position Paper, October 2008 (see attached);
- Remuneration of Non-Executive Directors, Position Paper, October 2008 (see attached);
- Non-Recourse Loans Provided to Executives, Position Paper, May 2008 (see attached);
- Executive Equity Plan Guidelines, Position Paper, March 2007 (see attached);
- Good Practice Guide to Remuneration Committees, 2004; and
- Shareholder Consideration of the Annual Remuneration Report of a Listed Company; A Guide for Consideration of the Issues, 2004 (see attached).

AICD is in the process of preparing further guidelines and educational materials to assist directors and others when dealing with executive remuneration matters. In particular, given the complexities associated

with the statutory annual remuneration report, AICD intends to issue guidelines to assist companies in the preparation of such reports.

Guidelines have also been issued by the ASX Corporate Governance Council and other associations (e.g. the Australian Shareholders Association, the Australian Council of Superannuation Investors, and the Investment and Financial Services Association Limited).

While we maintain further regulation of executive and NED remuneration is not required, should it be contemplated we consider an "if not, why not" disclosure-based regime, such as the one adopted by the ASX in respect of corporate governance matters[36], is the most appropriate. Such an approach caters for differences between companies, between individuals, and over time. It is also less likely to impede further development and refinement of good remuneration practices.

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

AICD considers there is a stronger case for further controls on remuneration where companies have received "bailout" funds from the Government, and these controls are "attached" to this financing in advance. This is not unlike seed capitalists attaching conditions to the provision of funds. We would caution, however, against the imposition of excessively restrictive conditions – on the basis this is likely to have adverse consequences for company performance.

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?

We note that when considering overseas laws or codes of good corporate governance practice, care must be taken not to import individual aspects in isolation (particularly where a problem overseas has been non-existent here). For instance, differences in prescribed or recommended practices may be driven by different legal, market or business environments, or because alternative mechanisms are used to address particular issues.

Australia already has a world class set of widely accepted good corporate governance practice guidelines in the form of the ASX Corporate

[36] ASX listing rule 4.10.3.

Governance Council's "Corporate Governance Principles and Recommendations".[37] These guidelines have broad market support and were developed after a consideration of approaches taken overseas.

Principle 8 ("Remunerate fairly and responsibly") of the guidelines state that "Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear". There are three recommendations under this Principle:

- *Recommendation 8.1*: The board should establish a remuneration committee.
- *Recommendation 8.2*: Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives.
- *Recommendation 8.3*: Companies should provide the information indicated in the Guide to reporting on Principle 8.

As noted above, there are also more detailed guidelines put out by other organisations – including by AICD. In particular, we draw the Commission's attention to the most recent set of executive remuneration guidelines released by AICD in February 2009. These guidelines discuss some things for boards "to do", some things "not to do" and some things "to think about". Some extracts are provided below.

Some things for boards to do:

- ensure the board maintains control of negotiations with CEO candidates, and where appropriate, other executives.
- undertake stress testing of proposed incentive arrangements before agreeing to variations or renegotiations.
- link incentive elements of remuneration packages to appropriate performance measures in such a way that short-term imperatives of the company are pursued while simultaneously promoting the company's long term interests.
- consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract.
- ensure remuneration packages are publicly defendable.

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[37] ASX Corporate Governance Council's "Corporate Governance Principles and Recommendations", 2nd Edition, 2007.

Some things not to do:

- have executives involved in setting their own remuneration for the obvious conflicts that may arise.
- overly rely upon advisers at the expense of board discussion and the exercise of board judgment.
- put in place arrangements that promote excessive risk-taking or short-termism.
- change performance hurdles midstream unless there is an exceptionally good reason or reasons.

Some things for boards to think about:

- whether to have a discretionary bonus rather than a bonus that the board is contractually obliged to approve regardless of changed circumstances.
- placing an upper bound on short-term and long-term incentive rewards, where such components exist, to minimise "surprises" of markets, products, and so on.
- putting in place arrangements whereby a percentage of a CEO's long-term equity incentive rewards is held for a period that extends beyond the term of the employment contract.
- engaging with major shareholders and other relevant stakeholders about the company's approach to remuneration, subject to continuous disclosure obligations.

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?

Remuneration Committees are widely used by Australia's largest 200 listed companies. This is largely because of the inherent complexities and potential conflicts of interest in remuneration considerations. Such Committees play a key role in assisting the Board to fulfil its corporate governance responsibilities in relation to remuneration issues, and provide a vehicle for enhancing the participation of non-executive directors.

For smaller companies, with smaller boards, it may not make a lot of sense to have a Remuneration Committee (e.g. cost constraints, less complexity). In such cases the entire board may undertake this role directly.

Because Remuneration Committees permit a more detailed focus on remuneration matters, outside of regular board meetings, and serve to address potential conflicts of interest, we believe they assist boards to put in place more effective remuneration arrangements, including determination of appropriate performance metrics.

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?

There are potential conflicts of interest when companies engage remuneration consultants to advise or remuneration issues. We consider these are able to be appropriately managed by boards.

In the case of executive remuneration, AICD has previously outlined some potential conflicts where executives are involved in the appointment of a remuneration consultant, or in reviewing work undertaken by the consultant. These are noted in AICD's publication "Executive Remuneration: Guidelines for Listed Company Boards"[38], together with some suggestions to boards as to how they might address such conflicts:

> *"If and when the board engages ....[search firms, legal advisers, remuneration consultants and other advisers to assist with the negotiation and formalisation of an executive's employment contract].... it must ensure the advice is commissioned by, and provided directly to, the board, independently of company management. For example, legal advisers negotiating the contract on behalf of the company (board), must receive instructions solely from the board and provide advice solely to the board.*
>
> *Any advice involving the law, tax, drafting techniques, and so on should go directly to the board and not through any executive unless that has been expressly authorised by the board (preferably in writing). Any remuneration consultant, including a consultant dealing with share plans, bonuses and the like, must also be engaged and must provide all reports, advice and so on, directly to the board. Regard should also be had to whether the advisers or consultants are, or have been, undertaking work commissioned by company executives. Good practice would ordinarily be for the board to engage different advisers and consultants to those engaged by executives."*

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[38] AICD, "Executive Remuneration: Guidelines for Listed Company Boards", February 2009.

Elsewhere in the Guidelines, AICD states:

> *"It is a fundamental principle of good corporate governance that executives should not be permitted to set their own rewards. Executives should not be involved in engaging consultants, such as lawyers and remuneration consultants for the purpose of setting CEO remuneration, or have the capacity in any way to influence the consultants' advice. This would give rise to significant conflicts of interest and undermine confidence in the company's governance arrangements."*

We note while the above matters may be appropriate for guidelines, they should not be incorporated into black letter law:

- this would add to existing red tape issues;
- there are often matters of difficult sensitivities and judgment involved;
- ultimately it is the board that is accountable for remuneration decisions; and
- there are already obligations for directors to act in good faith and in the best interests of the company.

In the case of NED remuneration we note again:

- NED remuneration tends to be considerably less in quantum when compared with executive remuneration;
- NED remuneration often involves a simple fee structure, which is relatively straightforward; and
- any increase in available director fee "pools" of listed companies is subject to shareholder approval.

AICD notes there have been suggestions by others that where a company has engaged a remuneration consultant(s) to assist in determining director and/or executive remuneration as set out in the company's remuneration report, the law should require that the consultant(s) be named in that report. AICD has no issue with companies making such disclosures, including the broad scope of the work undertaken, and indeed as a general proposition we consider this to be good practice. We do however have difficulty with this suggestion being mandated in all circumstances. We note that this position is different to that involving an auditor because the auditor prepares a report for shareholders, whereas a remuneration consultation provides advice to the board - advice which may or may not be taken up. Further, the ambit of a remuneration consultant's engagement

can vary considerably from company to company, depending in part on the extent to which boards rely on other advisers (e.g. law firms for employment contracts, accountants for data analysis). In any event, it is the board that remains responsible for the remuneration arrangements that are put in place.

B.4 TOR 3: The role of institutional and retail shareholders

Consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices.

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?

As noted above, the Board is the most appropriate body to be setting executive remuneration. Directors are elected by shareholders to make decisions that are in the best interests of the company they serve. This reflects the fact that it is not always practical or efficient for shareholders (particularly in public listed companies) to be making such decisions. Executive remuneration is a case in point given the potential complexities involved and the sometimes sensitive nature of discussions.

Shareholders in listed companies should, and do, have a say in the maximum amount of fees that can be paid to NEDs. With a maximum having been set by shareholders, it is then appropriate for the Board to determine, based on appropriate external advice and with subsequent disclosure to shareholders, how fees are split between individual directors. The split typically takes account of whether a director serves on a Board Committee(s) or serves as Chairman for the Board or a Board Committee. An additional safeguard is the law requires that the amount of remuneration paid to any individual director must be "reasonable", or otherwise approved by shareholders.

Through (re)electing individual directors, shareholders also have a direct say in who is involved in setting executive remuneration for the company. In addition, shareholders have:

- an advisory vote on the company's remuneration report each year that serves to indicate the level of satisfaction or otherwise that shareholders have with the remuneration arrangements their company board has approved;
- a say in relation to termination payments beyond a certain threshold (this threshold is being dramatically lowered); and

- (for listed companies) a say in relation to issues of new securities to directors (NED or executive).

As noted above, these requirements collectively extend far beyond what currently exists, for example, in the United States and elsewhere in the developed world.

In its Issues Paper the Commission states that "The ASX also recommends that companies submit to a vote any equity-based plans that involve the issue of new shares to senior executives (ASX Corporate Governance Council 2007)" (Issues Paper, p18). We note that this is incorrect. Firstly, the Guidelines referred to are those of the ASX Corporate Governance Council ("the Council"), not the Australian Securities Exchange (ASX). Secondly, the Council states by way of commentary (as opposed to one of the Council's 27 recommendations):

> "Under the Listing Rules and the Corporations Act companies are not generally required to obtain shareholder approval for equity-based incentive plans for senior executives who are not directors. However, companies may find it useful to submit to shareholders proposed equity-based incentive plans which will involve the issue of new shares to senior executives prior to implementing them." (emphasis added)

Does the current non-binding vote require strengthening?

The current non-binding voting regime does not require "strengthening". In particular, a binding shareholder vote on executive remuneration is undesirable because it is wrong in principle and unworkable in practice.

In practice a binding vote would be undesirable because:

- it would interfere with a system of governance which has generally worked well. The approach taken in the Act is based on shareholders electing members of the board, and the board selecting and overseeing senior executives, who in turn manage the company. Executive remuneration for CEOs (and certain direct reports) should be set by the board, who have oversight of the companies strategies and can adapt remuneration as appropriate over time.
- it would reduce the effectiveness of the board in managing the performance of the CEO and the company.
- it would reduce the board's ability to attract or retain appropriately qualified executives, as some potential candidates would be

unlikely to commit to a company where their remuneration or a major part of it is still to be determined.

- it is hard to envisage how companies will be able to enter into agreements effectively to secure the services of executives under such a regime, particularly in circumstances where an annual general meeting of shareholders has only recently occurred. In any event, there is additional risk for the executive concerned (particularly if they are leaving an existing job to join the company), which will no doubt need to be priced into the remuneration offered.
- a non-binding vote provides ample opportunity for shareholders to register their views, plus there has been significantly increased engagement with shareholders by Company Chairmen on remuneration and other issues.
- shareholder meetings are the wrong forum for detailed discussion and drafting of executive remuneration arrangements. One example given by Finance Minister Lindsay Tanner earlier this year is what would a board do if one third of shareholders agreed to one remuneration package, another third wanted a different package, and the final third wanted something else?[39]

In April 2009, AICD undertook research into voting results for non-binding resolutions put to shareholders at AGMs in the previous 12 months by companies in the S&P/ASX 200 Index (excluding entities such as trusts, foreign companies, etc that do not have such resolutions). Our findings were that, notwithstanding the market downturn, of those shareholders that cast directed proxy votes, an average of 11.3% were cast against the remuneration report. This figure would be materially lower when the direct votes cast against the remuneration report are compared to total company ordinary shareholdings, given that not all shareholders felt strongly enough to register a directed vote. Our research also revealed:

- only 9 companies had directed proxy votes of 50% or more against the remuneration report,
- 27 had a vote against of 20% or more, and
- 57 had a vote of 10% or more.

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[39] "Lindsay Tanner discusses the Pacific cuts", Insiders Programme, ABC TV, 1 March 2009. Finance Minster Tanner stated "But what happens for example if a third of the shareholders say $300,000 and a third say $600,000 and a third say $900,000? Where do you go there? What happens if the shareholders vote down a package? How do you then enter into a negotiation about what it should be? Do you hold a Dutch auction in a general meeting where you say you know, I'm starting with a million and let's see how far we go down?"

Again these figures would be lower if the votes cast against the remuneration report were compared with total possible votes from ordinary shareholdings.

We note the Commission's observation that in 2007 "two S&P/ASX 50 companies (AGL Energy and Telstra) saw their remuneration reports voted against, both by margins of greater than 20 per cent" (Issues Paper p18) . We believe it is worthwhile recognising that the voting outcome for these companies (90% for AGL and 95% for Telstra) improved significantly the following year (see Table 2), after the board in each case, presumably took into account shareholder concerns.

Table 3
Outcomes for Advisory Vote on 2008 Remuneration Report: AGL Energy and Telstra

	FOR	AGAINST	ABSTAIN
AGL Energy	150,517,256 (90%)	17,322,572 (10%)	1,505,612
Telstra	6,090,094,112 (95%)	287,791,415 (5%)	231,290,196

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?

There are arguments both ways as to whether directors and executives named in a remuneration report should be prohibited from voting their shares in relation to a non-binding resolution on that report. On the one hand, directors and executives could be said to "gain" if the advisory resolution is passed (i.e. through the voting outcome suggesting greater acceptance than otherwise of their remuneration arrangements). On the other hand, it could be argued that the purpose of the non-binding vote is to gauge overall shareholder reaction to the remuneration report, and as such directors and executives who are shareholders should be afforded a right to vote. The question ought be, why should a particular class of shareholders (executives, directors, etc) be disenfranchised in their capacity as shareholders. The law provides for situations involving conflicts of interest at the Board. On balance, we see little marginal benefit, if any, in prohibiting voting by those individuals named in remuneration reports, but we do not have a strong view on this issue. We do firmly believe, however, that proxies (directed or undirected) provided to the meeting Chairman by other parties (who aren't directors or named executives) should not be voided or disregarded. Shareholders should continue to be given the choice as to whether they provide proxies to the

meeting Chairman. If deemed necessary, a "health warning" statement, could be included in each notice of meeting.

To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers?

Institutional investors have a lot more influence than is generally recognised. We note, in particular, there has been a considerable increase in active engagement by large institutional investors on remuneration issues, particularly those institutional investors with longer term investment horizons. This occurs through the exercise of voting rights, but increasingly also through direct engagement out of the public limelight with company board members - in particular, the Board Chairman and/or the Remuneration Committee Chairman. Chairmen and NEDs are generally responsive about these approaches, but this occurs away from public view. Of course, continuous disclosure considerations apply.

Are there areas where their rights should be strengthened? Does institutional voting typically align with the broader interests of shareholders?

We do not believe institutional investors should be afforded rights over and above other shareholders. We believe their rights are appropriate, and in any event, institutional investors do not necessarily have homogenous interests as a group (e.g. large hedge fund - versus large industry superannuation fund - versus investment bank) or represent the same interests that other shareholder groups have.

We note in this context that proxy advisors who advise clients (institutional investors, etc) on how to vote on remuneration and other corporate governance issues can be influential regarding voting outcomes, yet they typically have no or little “skin in the game”. Such advisors face a potential "moral hazard" insofar as it could be said to be in their commercial interests to be highlighting their worth by finding fault with company governance arrangements. Given these circumstances we believe it is appropriate for consideration to be given to setting minimum standards of conduct. This might encompass greater transparency as to research that has been undertaken, assumptions made, contact with the company, etc.

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?

AICD believes that shareholders currently have an appropriate level of involvement in relation to a company's remuneration arrangements, including:

- shareholders of listed companies decide under the ASX listing rules whether or not new securities can be issued to directors (NED and executive);
- shareholders decide under the Act whether the company can provide termination benefits to directors or a person holding a managerial office beyond a certain threshold (this threshold is in the process of being lowered, and the range of individuals the requirement extends to is being expanded)[40]
- shareholders can seek a court order if they consider remuneration to directors is not reasonable; and
- shareholders are afforded an advisory vote on remuneration reports.

As noted above, shareholders also exert indirect influence over a company's approach to remuneration issues through who they (re)elect (or vote against) as directors.

One proposal that has been raised by others is the introduction of a binding shareholder vote on remuneration packages before they are settled. For reasons noted above, we believe such a requirement would be impractical and counterproductive. This proposal has no or little support in the business community including business organisations such as AICD and the Business Council of Australia, or amongst the key shareholder and investor groups for the same reasons.

Ultimately, in considering greater involvement by shareholders in executive remuneration matters, thought needs to be given to the practicalities. Shareholder meetings are not the right forum to be determining executive remuneration. The setting of executive remuneration, including an incentive structure that is appropriate in the company's circumstances, often involves matters of judgment, robust evaluation and scoring against potentially market sensitive criteria. It may mean a company has to move quickly and discreetly in order to entice an

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[40] See the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

executive away from another company. Apart from all the other impracticalities, public disclosure of all necessary details on which to make a sound remuneration decision is not always possible.

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B.5 TOR 4: Aligning interests

Consider, any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including but not limited to:
• the role of equity-based payments and incentive schemes
• the source and approval processes for equity-based payments
• the role played by the tax treatment of equity-based remuneration
• the role of accelerated equity vesting arrangements and
• the use of hedging over incentive remuneration.

To what extent do current taxation arrangements influence the level and structure of executive remuneration?

Experience from the United States shows that Government taxation policy can have a powerful influence on the structure of executive remuneration, but would appear to be relatively ineffectual as a tool in attempts at artificially limiting total remuneration packages (see above).

We note there is a tendency in Australia towards companies making lump sum payments on termination of executive contracts. The low incidence of arrangements that defer performance-based rewards beyond termination date is also noticeable. This has been driven largely by taxation laws. In particular, under Division 13A of the ITAA, a tax liability in respect of unvested equity securities under employee share schemes is triggered on cessation of employment. Tax concessions given in relation to employee share schemes are currently being reviewed, following the announcement of the Commonwealth Budget for 2009/2010. As noted above, AICD believes taxation laws should not work against companies putting in place arrangements that link executive rewards to appropriate long-term performance measures post-employment. We also note that until recently a more favourable tax treatment was afforded to termination benefits paid in a lump sum.

To what extent should bonuses be an allowable tax deduction for companies?

AICD considers that executive bonuses are a necessary and legitimate cost of doing business, and as such should be deductible. Not allowing bonuses to be deductible would be a retrograde step and would dampen investment and business confidence. AICD believes the United States experience demonstrates that removal of bonus deductibility is also likely

to result in distortions in other aspects of remuneration packages (e.g. base salary).

Should bonuses be subject to special/higher taxation rates?

To apply a higher tax rate to bonuses would make little sense. Tax revenues will increase if the economy grows and is productive. Bonuses can help companies and ultimately the economy and tax revenues grow. We also believe attempts to subject parts of remuneration packages (e.g. bonuses) to higher taxation rates in the hands of executives are likely to result in a shift in the basis of remuneration (most likely sub-optimally for the companies concerned). Such measures would have the potential to cause Australian executives and possibly businesses to move off-shore, and to make it more difficult (or expensive) for Australian companies to secure executives from overseas. We believe this in turn would have quite adverse consequences for Australian businesses and economic growth. It would also possibly signal a lack of understanding of business and/or an anti-business bias by Government, which could have a long-term damaging effect on the economy.

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?

We do not believe there is any evidence of systemic problems in the setting of executive remuneration by Australian boards from either a shareholder or a "wider community" perspective. There have of course been a relatively small number of much publicised examples of where, with hindsight, executive pay has not been in line with standard market practice. This does not of itself mean there has been an intentional misalignment of interests, or mischief. There may have been exceptional circumstances, or the board in question may have simply made a business judgment mistake. As we have mentioned elsewhere in this submission the setting of executive remuneration is a complex exercise and can have unintended consequences, particularly when they are rapid changes in industries or the economy more generally. This is not to suggest that shareholders or other external stakeholders would have necessarily done a better job than boards. Nor that prescriptive requirements or remuneration limits will make shareholders or the wider community better off.

What factors have contributed to any misalignment?

Factors that may have caused executive remuneration to be higher than they might otherwise have been include:

- complexities involved in setting remuneration (e.g. choice of performance hurdles).
- bull markets created circumstances where outcomes under long term incentive plans were well beyond executives' initial expectations and delivered rewards were substantial and beyond those expected by both the board and shareholders. Conversely, the current economic downturn is showing signs of an opposite effect.
- competition for scarce executive talent and increasing executive expectations as to remuneration during a boom time leading to increases in market remuneration levels faced by companies.

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?

We believe the first order question here should be what are the interests of the "wider community" in Australian businesses being successful. The short answer is that successful businesses contribute to broader economic growth, which in turn has benefits in the form of greater employment levels, a greater revenue base for Governments to provide services in the community, and the basis for a better general standard of living for most, if not all, Australians.

We would contend that securing the most appropriate people to lead companies, whether this is at the board or the senior executive levels, is a critical factor for the on-going success of most companies, and the size of returns afforded to shareholders and ultimately the economy. This is especially so in difficult times, such as those which currently exist.

It must be remembered that executive remuneration like many other strategies a company adopts is also part of its competitive advantage or disadvantage. Those companies that did a "better job" of setting executive remuneration during recent boom times are now in a better competitive space than those that did not; if only from a reputational stance.

We note, however, that corporate actions must occur within acceptable societal bounds, which are often set out in the law (e.g. environmental considerations, workplace safety issues). We also note that a company's conduct, if lacking, can quickly impact on the sustainability of a company's operations.

Can cost cutting by companies, including by sacking workers, align with the public interest?

While the laying off of workers is unfortunate, there will be circumstances where this is necessary or essential for some companies. This is part and parcel of having a free enterprise system, and usually such action is undertaken as a last resort. We do not believe it in the long term "public interest" to perpetuate activities that are uneconomic or involve an inefficient use of resources. We also note there are laws in place to protect employees in particular circumstances (e.g. unfair dismissal laws).

Is it reasonable to reward executives for actions that promote shareholder interests but which may not align with the public interest?

There are a multitude of laws governing acceptable corporate conduct (e.g. environmental laws, workplace safety laws, money laundering laws, etc). These laws in many cases are aimed at protecting the "public interest" and/or interests of various company stakeholders. We do not believe that the regulation of executive remuneration is the appropriate mechanism for defining "acceptable" bounds of conduct for corporations, particularly if, as is happening now, the market self corrects (see for example, current wage declines, freezes, etc).

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

The types of performance measures/hurdles that "could be used to accurately measure performance and align interests of executives and shareholders" will differ depending on the company, industry, economy wide performance, investor appetite for risk/return and so on.

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

The capacity for executives to "game incentives" these days is limited. By way of illustration, however, there are some well known examples as to how this might occur if unchecked by boards. A classic example of gaming is where remuneration is tied to reported profit, and accounting choices are made by management that have the effect of bringing forward reported revenue or deferring reported expenses. Another much cited example is where reported performance is tied to sales growth, and sales

growth is achieved but at the cost of other important factors (e.g. customer satisfaction, product quality, profit margins, risk etc).

Most boards today are aware of such gaming incentives, and take this into account when determining appropriate performance hurdles and how performance is measured.

In this context it is important to avoid what has been referred to in the United States as "executive capture". In the AICD Guidelines issued in February 2009 there is advice provided to boards to help ensure they have an appropriate remuneration setting framework in place. This advice included suggestions as to how boards can maintain control of negotiations with CEO candidates, and where appropriate, other executives.

The opportunity to game incentives is substantially lowered as a result of:

- better governance structures for executive remuneration;
- the role performed by NEDs in setting and reviewing arrangements; and
- transparency of arrangements.

Are boards properly exercising their functions on behalf of shareholders?

Yes, for the reasons outlined in this submission, we believe boards are properly exercising their functions in an extremely difficult area. To be clear, a director owes his or her duties to the company as a whole. This would normally coincide with the long-term interests of shareholders.

Another question that might be asked is who are the shareholders? Are they the long-term retail shareholders, day traders, managed funds (on behalf of beneficiaries), etc, and do they have common objectives?

Are they being unduly influenced by chief executive officers? If so, why?

There is no evidence to suggest that boards are being unduly influenced by CEOs in any systematic way. As noted above, the overall standard of corporate governance in Australia is highly regarded. By contrast to the United States, in Australia:

- a non-binding vote regime has existed since 2004;

- there is usually a separation between the Chairmen of the Board and the CEO (this is a requirement for APRA regulated institutions);
- there has long been a majority system of voting for directors; and
- there is a very comprehensive continuous disclosure regime.

Where there may be a problem, guidance is provided in the AICD's February 2009 Guidelines to assist in this area. An extract of this advice is provided below.

> *Do establish a remuneration committee of the board comprised entirely of non-executive directors, where the size of the company warrants this.*
> Because of the inherent complexities and potential conflicts of interest, remuneration issues should, wherever practicable, be dealt with by a subcommittee of the board, comprised solely of non-executive directors. The Remuneration Committee plays a key role in assisting the board to fulfil its corporate governance responsibilities on remuneration issues, and provides a vehicle for enhancing the participation of non-executive directors. The functions of the Remuneration Committee are to advise, recommend, monitor, and review remuneration decisions. However, the decisions on the matters with which the committee deals remain decisions of the board for which the entire board must take responsibility. The Remuneration Committee does not act for the board except where it is specifically delegated to do so under the company's constitution.
>
> *Do have in place remuneration processes that incorporate independent opinion, expertise and transparency.*
> In order to have confidence in remuneration outcomes, shareholders must have confidence in the processes adopted for determining executive remuneration. These processes should incorporate independent opinion, expertise and transparency. The use of non-executive directors on remuneration committees promotes independent opinion. Engagement of independent experts assists both independence and expertise objectives. Accountability to shareholders is aided through the company disclosing in its remuneration report how it makes remuneration decisions and what remuneration policies guide its decisions.
>
> *Do ensure the board maintains control of negotiations with CEO candidates and, where appropriate, other executives.*

> Negotiation of the CEO employment contract and, where appropriate, the contracts of the CEO's direct reports, is a matter for which the board must accept responsibility and control. The board or its duly-appointed representative must undertake these employment negotiations in the company's best interests. Sometimes the negotiations will be undertaken, on behalf of the board, by the board chairman, chairman of the Remuneration Committee or another member of the board, in each case operating under proper authority. Care should be taken to control any representations made to candidates on matters such as the state of the company, the achievability of performance hurdles, or the prospects of promotion, and so on. Boards may, and often do, engage experts to assist them with appointing executives, but the ultimate carriage of the negotiations must remain with the board.

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?

There are, of course, some possible forms of executive remuneration arrangements that are more likely than others to promote a misalignment of interests between executives and shareholders (e.g. arrangements that promote excessive risk taking), and some possible forms of NED remuneration arrangements more likely than others to promote a misalignment of interests between NEDs and shareholders (e.g. arrangements which compromise NED independence). The appropriateness of any given set of arrangements may well vary from company to company. AICD believes there are appropriate checks and balances that work against this misalignment occurring. See above for a discussion of these checks and balances.

Are taxation considerations, either from the company's or executive's perspective, driving the design of remuneration packages? If so, what changes are required?

Yes, taxation considerations (at either the corporate or the executive level) can influence (and sometimes determine) the design of remuneration packages. This has been seen in the public debate about the proposal in the 2009/10 Federal Budget concerning the changes to the taxation of employee share arrangements and the subsequent suspension of many share plans.[41]

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[41] See, for example, Damon Kitney, "Blunder turns into national fiasco as more schemes die", The Australian Financial Review, 22 May 2009, pp56-57.

As noted above, AICD believes there would be merit in examining the relevant parts of the ITAA that relate to termination benefits, especially in light of the proposed changes to termination benefits announced by Senator Sherry on 18 March 2009, and included in the draft Bill. In particular whether, under Division 13A of the ITAA, tax liability in respect of unvested equity securities under employee share schemes should continue to be triggered on cessation of employment, which promotes accelerated payments on termination and works against long-term executive incentive plans continuing post-employment. The best outcomes for executive remuneration can be enhanced or destroyed by taxation arrangements.

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?

Bonuses should continue to be an allowable deduction for taxation purposes. A reduction in deductibility for one aspect of remuneration packages is likely to lead to a “squeezing of a balloon” effect towards another part(s) of the package. Ultimately it will be shareholders who lose. From a "public interest" point of view, a higher cost of equity capital, has implications for business activities, which in turn adversely impacts economic prosperity (e.g. employment levels, standard of living, etc).

Attempts by legislators overseas to proscribe aspects of executive remuneration have often been ill-advised, and counterproductive or of marginal utility:

- in 1984[42], US Congress passed a law eliminating the tax deductibility of golden parachutes that exceeded three times base salary. A level just under this became the norm[43].
- in 1993[44], US Congress said only $1 million of an executive's salary would be tax deductible. There was a “squeezing of the balloon” effect in short term incentives and long term incentives[45].

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[42] The Deficit Reduction Act of 1984 (U.S.), which added sections 280G and 4999 to the Inland Revenue Code.

[43] See for example Randy Myers, “ Minimize Parachute Penalties: Techniques are available to soften the impact of parachute payments”, October 2001 – available at http://www.journalofaccountancy.com/Issues/2001/Oct/MinimizeParachutePenalties.htm

[44] The Omnibus Budget Reconciliation Act of 1993 (U.S.), Section 162(m) of the Internal Revenue Code (IRS par. 9001B, sec. 1.162).

[45] See Martin Gritsch and Tricia Coxwell Snyder, “The impact of current tax policy on CEO stock option compensation: a quantile analysis”, Academy of Accounting and Financial Studies Journal ,

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On 6 September 2006, Christopher Cox, the then Chairman of the U.S. Securities and Exchange Commission, testified at a U.S. Senate Committee on Banking, Housing and Urban Affairs that "One of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993".[46]

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?

We believe there may be a case for differentiated oversight of remuneration practices where there are systemic risk issues. The focus here should be restricted to whether remuneration arrangements (for executives and others) materially increase the risk profile of the company. There is already a prudential framework governing such companies, and APRA is in the process of considering how that framework should deal with remuneration issues[47]. We do not believe, however, that this should extend to prescriptive requirements for executive remuneration as to interfere with the market is likely to have an adverse effect on executive remuneration or very likely some adverse consequences like those already referred to above.

Are there other sectors that would require a differentiated approach?

No, we do not consider there are other sectors (beyond those that present systemic risk issues) which require a differentiated approach to the oversight of executive remuneration.

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

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

Sept, 2005 available at http://findarticles.com/p/articles/mi_hb6182/is_3_9/ai_n29241561/?tag=content;col1

[46] The testimony is available at http://www.sec.gov/news/testimony/2006/ts090606cc.htm.

[47] See " APRA outlines approach on executive remuneration" APRA Media Release, 9 December 2008. Available at - http://www.apra.gov.au/Media-Releases/08_32.cfm

Shareholder votes on remuneration reports should not be binding. To our knowledge there is no overseas jurisdiction that has a binding shareholder vote on executive remuneration packages (this includes the Netherlands and Norway - which are cited in the Commission's Issues Paper as having a binding vote).

As noted above, a binding vote would have both conceptual and practical problems. In practice it would be undesirable because:

- it would interfere with a system of governance which has generally worked well. The approach taken in the Act is based on shareholders electing members of the board, and the board selecting and overseeing senior executives, who in turn manage the company. Executive remuneration for CEOs (and certain direct reports) should be set by the board, who have oversight of the companies strategies and can adapt remuneration as appropriate over time.
- it would reduce the effectiveness of the board in managing the performance of the CEO and the company.
- it would reduce the board's ability to attract or retain appropriately qualified executives, as some potential candidates would be unlikely to commit to a company where their remuneration or a major part of it is still to be determined.
- it is hard to envisage how companies will be able to enter into agreements effectively to secure the services of executives under such a regime, particularly in circumstances where an annual general meeting of shareholders has only recently occurred. In any event, there is additional risk for the executive concerned (particularly if they are leaving an existing job to join the company), which will no doubt need to be priced into the remuneration offered.
- a non-binding vote provides ample opportunity for shareholders to register their views, plus there has been significantly increased engagement with shareholders by Company Chairmen on remuneration and other issues.
- shareholder meetings are the wrong forum for detailed discussion and drafting of executive remuneration arrangements. One example given by Finance Minister Lindsay Tanner is what would a board do if one third of shareholders agreed to one remuneration package, another third wanted a different package, and the final third wanted something else? (see above).

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

AICD believes the current approval processes for equity-based remuneration are appropriate. In particular, we consider that ASX listing rule 10.14 should:

- remain limited to circumstances involving the dilution of shareholder interests through the issue of new securities; and
- continue to apply to directors and their associates but not be extended to executives.

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

It is widely acknowledged that the hedging of securities by directors/executives can lessen the alignment of their interests with those of shareholders. AICD has previously set out its views on good corporate practice regarding executive option hedging:

- It is prudent for companies to have a written and published policy for the hedging of executive options.
- The hedging of options should be prohibited by companies during the pre-vesting period, particularly where the company has informed the market that a portion of remuneration is "at risk".
- Companies need to consider their individual circumstances in relation to securities that have already been vested. Some of the more conservative views indicate companies should disclose hedging arrangements in respect of executive options.
- Companies should consider a mechanism by which executives are required to report hedging of executive options.
- Any current or emerging breaches of policy should be treated seriously, and where appropriate, disclosed to the market.[48]

Similar principles would apply in relation to the hedging of shares.

We note that the ASX Corporate Governance Council has subsequently stated "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

[48] "Trading Away Disclosure Responsibilities", Company Director, August 2006, p25.

schemes"[49]. Also "Where a company makes any representations about the alignment of a senior executive's interests, the company should take into account the extent of that senior executive's alignment of interest based on any disclosure under the company trading policy".[50]

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

As noted by the Commission, AICD considers that the provision of non-recourse loans to executives does not typically represent "best" corporate governance practice, because such loans weaken the link between performance and rewards by diluting the "at risk" aspect of share ownership (i.e. the personal wealth of the executive is not at risk if the company's share price falls). In addition, where there is a dramatic fall in company share price, shareholders can lose out twice – the fall in value of their personal holdings as well as the loss to the company because the loan is not recouped.

AICD does believe, however, the current regulation of non-recourse loans is appropriate on the basis that non-recourse loans to senior executives are subject to disclosure in remuneration reports and/or under continuous disclosure requirements if material. As a matter of principle the appropriateness of non-recourse loans should be left to boards and market forces. We note that further legislative intervention would be at odds with the approach policymakers have taken in respect of other corporate governance matters, and other elements of executive remuneration. It is important to recognise the role played by the ASX Corporate Governance Council, its pronouncements, and the "if not, why not" regime that is in place. This has been a successful alternative to black letter law for corporate governance matters generally.

AICD has published a position paper on non-recourse loans to executives and we refer the Commission to this.[51]

- ***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?***

Remuneration consultants can play an important role in assisting boards to design remuneration arrangements and determine appropriate

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[49] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations", 2nd Edition, p36.
[50] Ibid.
[51] http://www.companydirectors.com.au/Policy/Policies+And+Papers/2008/Position+paper+no.+8+-+Non-Recourse+Loans+Provided+to+Executives.htm.

remuneration levels. Boards may or may not choose to follow the advice such consultants provide.

Below is some of the guidance that AICD has provided to directors in this area:

> ***"Do obtain appropriate expert advice, independent of company management, when entering into employment contracts with executives and setting their remuneration.***
>
> *Remuneration arrangements for executives have become increasingly complex. Boards cannot be expected, in isolation, to be completely across the legal, financial modelling, accounting and tax aspects of many of today's executive remuneration packages, the intricacies of incentive plan design, market trends, and so on. Furthermore, many boards, particularly of modest scale companies, do not engage in this type of activity frequently and may in fact only seek to appoint a CEO every five-to-ten years. It may be the case that no member of the board including its chairman has the experience or skill to undertake these employment negotiations alone. It has become commonplace for companies to engage search firms, legal advisers, remuneration consultants and other advisers to assist with the negotiation and formalisation of an executive's employment contract.*
>
> *If and when the board engages these advisers and consultants, it must ensure the advice is commissioned by, and provided directly to, the board, independently of company management. For example, legal advisers negotiating the contract on behalf of the company (board), must receive instructions solely from the board and provide advice solely to the board.*
>
> *Any advice involving the law, tax, drafting techniques, and so on should go directly to the board and not through any executive unless that has been expressly authorised by the board (preferably in writing). Any remuneration consultant, including a consultant dealing with share plans, bonuses and the like, must also be engaged and must provide all reports, advice and so on, directly to the board. Regard should also be had to whether the advisers or consultants are, or have been, undertaking work commissioned by company executives. Good practice would ordinarily be for the board to engage different advisers and consultants to those engaged by executives. While some of these practices sound unduly strict, they are necessary to ensure the confidentiality and integrity of processes*

and the proper functioning of the board, and to avoid conflicts of interest. Experience shows that unless these fundamental principles and precautions are adopted, the chance of things "going off the rails", whether at the time of negotiation or in subsequent years, is more likely."

"Do not overly rely upon advisers at the expense of board discussion and the exercise of board judgment.

Boards are accountable for decisions made about executive remuneration, and should not treat expert advice as a substitute for exercising their own judgment. Under section 189 of the Corporations Act, reliance by a director on information, or professional or expert advice, about matters such as remuneration issues is taken to be reasonable if the reliance is made in good faith and after making an independent assessment of the information or advice. Ultimately, however, the board is answerable for the remuneration arrangements it approves.[52]

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

AICD believes that the Government should not take on a greater role in regulating remuneration. In fact there is a very strong argument that the draft Bill issued by the Government is not in the best interests of companies, shareholders or the community generally (see our attached submission to Treasury about the draft Bill).

An exception may be where a company has been the recipient of public monies as a result of a "bailout", in which case we consider it may be appropriate for the Government, as a supplier of funds (or owner of shares), to attach remuneration requirements it considers necessary at the time of the bailout. The particular requirements should be considered on a case by case basis and be able to be adapted over time depending on the circumstances of the relevant case.

AICD considers the way to address the current disquiet regarding some remuneration arrangements lies in educating and training directors, boards and others, rather than promulgation of further legislative requirements. Some companies will not need this further education, but for others there may be a need to rethink existing approaches given

[52] AICD, Executive Remuneration: Guidelines for Listed Company Boards, February 2009

inherent difficulties. In this regard AICD has issued various guidelines (see above), held briefings, engaged in dialogue with members, etc.

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?

Companies can be viewed as a "coalition of competing interests". Boards play an important role in appropriately balancing the sometimes competing interests of stakeholders (different shareholders, executives, other employees, creditors, governments, etc) to help promote the long-term sustainability of the companies they serve. This is reflected in the fundamental legal duty that directors have to act in the best interests of the company as a whole, rather than any one stakeholder group.

The interests of shareholders can differ between individuals or shareholder groups. Shareholders may have a short, medium or long term horizon. They may be located domestically or offshore. They may be seeking to outperform indices, or holding shares as part of a hedge strategy. They may be institutional or retail. They may be active or passive. And so on.

In recent decades, it has been widely accepted that the inclusion of a performance-based element in executive remuneration is desirable in order to more closely align interests of executives and shareholders. There is, however, on-going debate as to the most appropriate performance metrics (which are likely to vary from case to case), and suitable time horizons. There is also a debate emerging as to what executives and companies can control, and how in fact markets operate.

While it is appropriate that companies operate within acceptable societal bounds (e.g. levels of pollution, false and misleading conduct, etc), we consider that executive remuneration to be part of the inter-workings of companies, and should not as a general rule be the subject of further Government regulation on the grounds of "wider community interests". We believe this issue goes to the heart of our free enterprise system and freedom more generally.

What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?

We discuss elsewhere in this submission the possible unintended consequences of heavy handed regulation of executive remuneration. In short, these possible unintended consequences include:

- Inability to attract the most appropriate executives, with consequential effects for company performance and broader economic growth.
- Loss of local talent overseas or to other sectors of the economy.
- Potential "squeezing of the balloon" effect, with the result that the regulation does not achieve its designed aim of limiting executive remuneration.
- Requiring lawyers and other advisors to sit with boards throughout any executive remuneration discussion to advise on the liability of company and individual directors. This would substantially increase transaction costs and put smaller companies potentially at a disadvantage.
- Taking away the entrepreneurial spirit which is what is needed to keep a viable and vigorous economy.
- Discouraging professional and talented directors from taking board positions in the listed company space. This could have a long term disadvantage for the various groups the Government is trying to protect, such as shareholders, investors, superannuation funds and the Government itself (e.g. Future Fund).

B.6 TOR 5: International developments

Consider the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances.

Are there any international approaches particularly applicable to Australia?

Australia has corporate governance practices that are among the best in the world (see above). If comparisons are made with particular overseas practices or requirements, it is important to also consider the context in which the latter exist. Different practices may be explained by a variety of factors including different legal, taxation, market or cultural environments. For example:

- unitary versus two-tiered board structures,
- environments characterised by shareholder activism versus shareholder passivity,
- prevalence of NEDs versus executive heavy boards,
- general cultural of compliance versus widespread malfeasance,
- common law versus civil law jurisdictions,
- the current state of corporate governance in the relevant country and in a particular industry (e.g. compare Australian APRA regulated entities to those in the United States).

We note Australia's approach to corporate governance issues generally has tended to be disclosure based, and for good reason. This has permitted companies to put in place practices that are the most appropriate in their circumstances, and aided the development of enhanced corporate governance arrangements.

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

Experience overseas shows that prescriptive regulatory approaches to executive remuneration have often been ill-advised, and counterproductive or of marginal utility. Two legislative changes (also referred to above) help to illustrate this:

- in 1984, US Congress passed a law eliminating the tax deductibility of golden parachutes that exceeded three times base salary. A level just under this became the norm.
- in 1993, US Congress said only $1 million of an executive's salary would be tax deductible. There was a “squeezing of the balloon” effect in short term incentives and long term incentives.

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ATTACHMENTS (indexed)

1. AICD's response to "Exposure Draft: Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009", dated 28 May 2009.
2. Letter from Russell Reynolds Associates to AICD dated 25 May 2009 discussing the global market for executives
3. Letter from Korn/Ferry International to AICD dated 28 May 2009 discussing the global market for executives
4. Executive Termination Payments, AICD Position Paper, October 2008.
5. Remuneration of Non-Executive Directors, AICD Position Paper, October 2008.
6. Non-Recourse Loans Provided to Executives, AICD Position Paper, May 2008.
7. Executive Equity Plan Guidelines, AICD Position Paper, March 2007.
8. Shareholder Consideration of the Annual Remuneration Report of a Listed Company; A Guide for Consideration of the Issues, 2004.
9. CEO Report, "Executive remuneration – Time for a Rethink?", Company Director Journal, December 2008/January 2009.
10. CEO Report, "Guidance on Executive Remuneration", Company Director Journal, March 2009.