Response to the Productivity Commission on its draft executive remuneration recommendations

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PRICEWATERHOUSECOOPERS

Consulting

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Introduction and Executive Summary

PricewaterhouseCoopers' (PwC) welcomes the opportunity to respond to the Productivity Commission's draft recommendations. In our submission, we have responded only to certain recommendations on remuneration and its governance.

We are supportive of Recommendations 2, 3, 9, 10 and 13 and we have not commented on Recommendations 1, 7, 12 and 14.

In respect of Recommendation 4 (the prohibition of key management personnel and their associates voting on remuneration-related resolutions), we agree with the intention of this recommendation. However, we suggest that it is more appropriate for this recommendation to be incorporated into the ASX Corporate Governance Guidelines ("ASX Guidelines"), rather than into the Corporations Act.

This is because there are examples of companies where the vast majority of shares are owned by directors (or their associates) and in this situation it is not appropriate for the minority of shareholders to dictate the remuneration policies for a company where the directors (or their associates) are the major shareholders and believe that the remuneration policies are structured appropriately. Structuring this recommendation as a guideline sends a message that it is best practice for these personnel not to vote on remuneration-related resolutions however it also gives companies the ability not to comply with this requirement, and explain why not, if they believe it is not appropriate given their specific circumstances.

In respect of Recommendation 5, which covers the hedging of employee equity, we do not believe it is appropriate for executives to hedge any unvested equity. If, however, the equity has vested, and the executive is absolutely entitled to that equity, we suggest that executives should be able to hedge this equity if they so desire.

We do not support Recommendation 6 (voting of undirected proxies) because we do not believe that there is any rationale for the voting of undirected proxies to be handled in a different manner for remuneration-related resolutions compared to other resolutions. We believe the current process of providing shareholders with the ability to request that the Chairman (as proxy for the shareholder) vote as they see fit is appropriate and should be maintained for all resolutions.

We agree with Recommendation 8 (remuneration disclosure), in principle, however we note that there are practical issues to work through, such as defining what is meant by "actual remuneration", particularly when it comes to long-term incentives. We suggest that an alternative for consideration may be for the disclosed value to reflect the value of shares and rights at the time of vesting and the value of options at the time of exercise.

We also agree that disclosure of total company shareholdings of the individuals named in the report provides useful information, however given that this information is already disclosed elsewhere in the financial report, we would not support a proposal that created duplication.

As stated, we are supportive of Recommendation 10 and agree that remuneration committees (and boards) should directly engage, and work directly with, their external remuneration advisor. We also suggest that it would be appropriate for a voluntary code of conduct to be adopted by Australian executive remuneration advisors and that this cover management of conflicts and objectivity. This is so the board or remuneration committee has comfort that any advice received from the advisor is independent of management.

In respect of Recommendation 11 (disclosure of expert advisors), we are supportive of this proposition on an "if not, why not" basis. However, further guidance should be provided to companies in respect of how they should meet this recommendation to ensure shareholders understand the role that the advisor has played.

Introduction and Executive Summary (cont'd)

In relation to Recommendation 15, we support the Productivity Commission's view that where a company receives a "no" vote of 25% or higher that the board is required to report back to shareholders in the subsequent remuneration report explaining how they have addressed shareholder concerns or, if they have not addressed the concerns, the reasons why.

In order to do this effectively, we suggest that where the 25% threshold has been breached that the Chairman of the Remuneration Committee be required to undertake stakeholder consultation to ensure it has a thorough understanding of the reasons why the company received the high "no" vote. We also suggest that at this stage the Chairman of the Board should become personally involved in the Remuneration Committee (if not already) to review the processes and realign remuneration with strategy and / or conduct a review of executive remuneration pay structures.

We do not support the Productivity Commission's recommendation that if the company's subsequent remuneration report receives a "no" vote higher than a prescribed threshold that all elected board members are required to submit themselves for re-election. This is because this part of the recommendation goes against generally-accepted governance principles.

Shareholders elect the directors of the board to act on their behalf in terms of determining the company's strategy, and this includes the remuneration strategy. Directors, in turn, have a fiduciary duty to shareholders to act in their best interests. If shareholders are not comfortable that a director, or the full board, is acting in their best interests, then they have the mechanism already in place not to re-elect the director when the director presents himself / herself for re-election. Shareholders would have the ability to do this within a maximum three year period which is the same period as would apply under the "two-strikes test" provided that no EGM was held.

Reducing conflicts of interest

We are supportive of Recommendations 2 and 3. We also support Recommendation 4, however suggest that this is incorporated into the ASX Guidelines rather than into the Corporations Act.

Recommendation 2: *A new ASX listing rule should specify that all ASX 300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.*

This recommendation reflects the current commentary in the ASX Guidelines and we agree it is appropriate for this commentary to be elevated into the ASX listing rules for ASX 300 companies.

We are not supportive of this proposed listing rule being extended to all listed companies. This is because it may not be appropriate for all listed entities to comply with this requirement given the various size and ownership structures of the smaller companies listed on the ASX. If the ASX Corporate Governance Council does not adopt Recommendation 3, we still believe that Recommendation 2 should remain as currently drafted.

Recommendation 3: *The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a "comply or explain" recommendation which specifies that remuneration committees:*

- *have at least three members;*
- *be comprised of a majority of independent directors; and*
- *be chaired by an independent director.*

We are supportive of this recommendation. This recommendation may not be appropriate for all listed companies (as noted above), however having this recommendation structured as a guideline means that companies can meet this requirement on an "if not, why not" basis.

Recommendation 4: *The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions.*

We agree with the intention of this recommendation, however we suggest it is more appropriate for this recommendation to be incorporated into the ASX Guidelines, rather than into the Corporations Act. This is because there are examples of companies where the vast majority of shares are owned by directors (or their associates). In this situation, it is not appropriate for the minority of shareholders (say, 15%) to dictate the remuneration policies for a company where the directors or their associates are the major shareholders and believe that the remuneration policies are structured appropriately.

Incorporating this recommendation into the ASX Guidelines sends the message that it is best practice for key management personnel (and their associates) not to vote on remuneration-related resolutions. However, it does give companies the ability not to comply with this requirement if they believe it is not appropriate given their specific circumstances. Where key management personnel and their associates do vote their shares, it may also be appropriate for the company to separately disclose the voting outcomes for these personnel versus all other shareholders.

Reducing conflicts of interest (cont'd)

In respect of Recommendation 5, we believe that executives should be able to hedge their vested equity even if it remains subject to a holding lock. We are not supportive of Recommendation 6 because we do not believe there is any rationale as to why the voting of undirected proxies should be different for remuneration-related resolutions compared to other resolutions.

Recommendation 5: *The Corporations Act 2001 should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.*

We do not believe it is appropriate for executives to hedge their unvested equity because the value of this equity may never be realised if performance conditions and / or time-based vesting conditions are not achieved. More importantly, the act of hedging unvested shares effectively reduces the impact of the desired performance and shareholder alignment.

If, however, the equity has vested, albeit it remains subject to a holding lock, we suggest that executives should be able to hedge this equity if they so desire. This is because once the equity has vested, the executive is absolutely entitled to it and, subject to trading restrictions and company policies, it becomes similar to other personal investments.

Recommendation 6: *The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.*

We are not supportive of this recommendation because we do not believe that there is any rationale for the voting of undirected proxies to be handled in a different manner for remuneration-related resolutions compared to other resolutions.

We believe the current process of providing shareholders with the ability to request that the Chairman (as proxy for the shareholder) vote as they see fit is appropriate and should be maintained for all resolutions. In acting this way, shareholders are making the conscious decision to permit the Chairman to vote on their behalf, recognising it is likely that the Chairman will vote in favour of the resolution.

Improving relevant disclosure

We are supportive of Recommendation 8 in principle, however there are some practical issues that need to be considered.

Recommendation 8: *Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include:*

- *a plain English summary statement of companies' remuneration policies*
- *actual levels of remuneration received by executives*
- *total company shareholdings of the individuals named in the report.*

Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.

We welcome the proposals that are directed at simplifying and improving disclosure in the remuneration report. The current requirements have resulted in remuneration reports that have become lengthy, complex and very difficult for the typical investor to understand.

Including a plain English summary statement of companies' remuneration policy

We support the proposal to include a plain English summary of companies' remuneration policies. Many companies already spend considerable time trying to make their remuneration reports as readable as possible, however many also use "boilerplate" language that is difficult to understand and that may not best reflect a company's specific policies. We also acknowledge and support the Productivity Commission's comments that whilst a regulatory requirement for "plain English" may be difficult to enforce, it would be a useful signal to companies to provide more "shareholder-friendly" reports.

Disclosing actual levels of remuneration received by executives

We support the proposal for companies to disclose actual levels of remuneration received by executives.

The disclosure of equity-based compensation has consistently caused confusion to shareholders since it is an accounting charge based on a grant date fair value in accordance with the relevant accounting standards and therefore does not reflect the "take-home" pay of the executive. It is important for remuneration to be disclosed in this manner because the amount disclosed reflects the "cost to the company" of its remuneration plans, however we suggest it is also helpful for shareholders to understand the actual levels of remuneration received by executives. This would lead to less ambiguity and confusion around remuneration reports.

The challenge, however, will be in defining what is meant by "actual levels of remuneration", particularly in relation to long-term incentive plans. One potential alternative is for the disclosed value to reflect the value of shares and rights at the time of vesting and the value of options at the time of exercise. We suggest that a working group be established to determine a consistent basis of measurement that would align with the needs of users of the remuneration report.

If the grant date fair valuation was disclosed only in the financial statements, we would support disclosure by individual key management personnel, and in aggregate, if this information is useful to investors.

Total company shareholding of individuals disclosed

Whilst we agree that disclosure of total company shareholdings of the individuals named in the report provides useful information, given that this information is already disclosed elsewhere in the financial report, we would not support a proposal that created duplication. A potential solution may be to either ensure that the remuneration report clearly cross references to information elsewhere in the financial report or to permit companies to transfer the information that would otherwise be in the financial report to the remuneration report.

Improving relevant disclosure (cont'd)

We are supportive of Recommendations 9 and 10.

Recommendation 9: *Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.*

We support the proposal to confine individual remuneration disclosures to the key management personnel of the company.

The disclosure of the five highest paid executives is a legacy disclosure from a previous reporting regime and we support the move to align the Corporations Act requirement with accounting standards. This will reduce the detail and length of remuneration reports and reduce compliance costs for companies.

In our view, it would be unhelpful to investors to further confine individual disclosure to the CEO and the "top" key management personnel. It is uncertain as to how a "top" KMP would be defined and this potentially creates opportunities for companies to avoid disclosure of an individual's remuneration. This would also seem to create a difference between the Corporations Act requirements and Accounting Standards which would not be preferable.

Recommendation 10: *The ASX listing rules should require that, where an ASX 300 company's remuneration committee (or board) makes use of expert advisors, those advisors be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.*

We agree that remuneration committees (and boards) should directly engage, and work directly with, their external remuneration advisor. The role of the external advisor is to provide an independent perspective (without undue influence from management) to the remuneration committee when it is considering the company's remuneration arrangements.

We suggest it would be appropriate for a voluntary code of conduct to be adopted by Australian executive remuneration advisors (similar to what has been proposed in the Walker review[1]) and that this cover management of conflicts and objectivity so that the board or remuneration committee has comfort that any advice received is independent of management. We believe it is appropriate for an Independent Chairman to oversee compliance with the voluntary code of conduct. See Appendix A for a summary of the Good Practice Guidelines recommended by Walker in respect of objectivity.

In supporting the Remuneration Committee, it is often important for the remuneration advisor to liaise directly with management to ensure a clear understanding of the relevant business issues and context. This means speaking to and seeking information from HR, Finance and Risk representatives and the executives themselves – whether that means reviewing proposals put forward by management or in formulating their own suggestions.

The above protocols should enable the firm of the remuneration advisors to work with both the board and management on different engagements. This is because when the advisors are working directly for the board, their independence will remain intact. For example, it would not be appropriate for the remuneration advisor to act on behalf of any individual executive on remuneration design and / or quantum.

1. *A review of corporate governance in UK banks and other financial industry entities,* 16 July 2009.

Improving relevant disclosure (cont'd)

We are supportive of Recommendation 11, however suggest that further guidance is provided to ensure disclosures are not misleading.

Recommendation 11: *The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisors they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisors.*

We are supportive of the proposition for companies to disclose their remuneration advisors on an "if not, why not" basis, however further guidance should be provided to companies in respect of how they should meet this recommendation.

For example, often remuneration advisors may advise the board or management on specific remuneration arrangements rather than the company's entire remuneration strategy. Accordingly, if remuneration advisors are named, the broad nature of the advice requested should also be disclosed. We also suggest that this recommendation only apply if the board or remuneration committee acted upon the advice of the remuneration consultant as otherwise the disclosures will be misleading.

We suggest it is not necessary to disclose who appointed the advisor and who they worked for, instead the recommendation could be changed to require companies to disclose the protocols they have put in place to ensure that advisors engaged by the board or the remuneration committee provide their advice independently of management. Again, we suggest that this be on an "if not, why not" basis.

We also do not believe it is necessary for the company to be required to disclose the nature of other work undertaken for the company by the remuneration advisor. This is because firms can legitimately provide other services to companies, such as tax, accounting, legal or other consulting advice, where they advise the Remuneration Committee, provided that appropriate safeguards and practices are in place.

Well-conceived remuneration policies

We agree with the Productivity Commission that remuneration structures are company and context-specific and that the board should have ultimate accountability over these arrangements. We are also supportive of relevant remuneration disclosures.

Draft finding 1: *Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, there are some key dimensions that often warrant being explained clearly to shareholders, and where appropriate, could usefully be addressed in companies' treatment of their remuneration policies in the remuneration report:*

- *how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests*
- *how the mix of base pay and incentives relates to remuneration policy*
- *how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected*
- *how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes*
- *whether any incentive compatible constraints or caps to guard against extreme outcomes from formula-based contractual obligations apply*
- *whether alternatives to incentives linked to complex hurdles have been considered*
- *whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to "buy-out" poorly performing executives in order to avoid litigation*
- *whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.*

We are in agreement with the Productivity Commission that remuneration structures are company and context-specific and that the board should have ultimate accountability over these arrangements. We are also supportive of relevant disclosures to assist shareholders in understanding the company's remuneration policy and how this links to strategy.

The key dimensions suggested by the Productivity Commission should be considered by boards, and may be incorporated into guidelines, however they are not all matters that necessarily require disclosure. That said, we agree that companies should explain in their remuneration report how remuneration policy aligns with the company's strategic direction and with shareholder interests, and how the mix of base pay and incentives relates to remuneration policy.

Given APRA's focus on requiring risk to be incorporated into the remuneration framework for APRA-regulated institutions (including banks and insurance companies), it is likely that such institutions will also be explaining how the remuneration policy aligns to its desired risk profile going forward.

The Corporations Act and accounting standards already require disclosure in relation to performance metrics. In addition, companies are able to provide additional information, however it may be practically difficult to determine the level of appropriate disclosure requirements across all companies. This is because performance metrics, particularly short-term incentive metrics, are typically very customised to a company's specific circumstances. Accordingly, further disclosure is likely to result in remuneration reports becoming more lengthy and complex with little associated benefit.

Well-conceived remuneration policies (cont'd)

We are supportive of Recommendation 13.

We also query whether it is necessary for companies to disclose how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes, however companies should undertake this analysis. We believe that having an overriding discretion over all incentive plans is the better approach than implementing caps or other constraints to protect against unexpected or unintended outcomes.

With the regard to the suggestion of disclosing alternative incentive plan designs, remuneration reports are complex enough without explaining the rationale as to why alternative incentive plan designs were considered and disregarded.

The proposed terminations payments regime will significantly limit termination payments permitted to be paid to key management personnel without shareholder approval. In addition, key contractual terms for key management personnel are required to be disclosed in the remuneration report under the Corporations Act and accounting standards. Accordingly, the current regime around disclosure and the proposed regime around the payment of termination benefits is appropriate and that no further disclosure is necessary in this regard.

We agree that it is appropriate for companies to disclose whether there has been a post-remuneration evaluation to assess the outcomes and effectiveness of the remuneration policy.

Recommendation 13: *The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.*

We are supportive of this recommendation and are disappointed with the Government's decision not to adopt this recommendation in its legislation on the taxation of employee share schemes that was introduced into Parliament in October 2009.

We agree with the Productivity Commission's view that local and international regulators are encouraging greater deferral periods, often post termination, in order to encourage executives to focus on longer term performance.

In addition, having a cessation event at termination does indeed create a significant disincentive for companies to structure vesting periods that continue on after the executive's termination of employment. Due to the current taxation structure, and companies not wanting to place their executives in an adverse cash-flow position, many companies permit the acceleration of all, or a portion of, the unvested equity, which is not in the best interests of shareholders. If cessation of employment were to be removed as a taxing point, companies would be more inclined to keep the unvested equity "on-foot" subject to the original performance conditions and time periods. This would create much better alignment between departing executives and shareholder interests.

Facilitating shareholder engagement

We are supportive of Recommendation 15 requiring companies to report back to shareholders if they receive a "no" vote of 25% or higher on their remuneration report. We are not supportive of the recommendation for the board to submit themselves for re-election if the subsequent "no' vote on the remuneration report is above a prescribed threshold.

Recommendation 15: *The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a "no" vote of 25% or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were address and, if they have not been addressed, the reasons why.*

If the company's subsequent remuneration report receives a "no" vote above a prescribed threshold, all elected board members be required to submit for re-election (a two-strikes test) at either an extraordinary general meeting or the next annual general meeting.

We support the Productivity Commission's recommendation that where a company receives a "no" vote of 25% or higher that the board is required to report back to shareholders in the subsequent remuneration report explaining how they have addressed shareholder concerns or, if they have not addressed the concerns, the reasons why.

In order to do this effectively, we suggest that where the 25% threshold has been breached that the Chairman of the Remuneration Committee be required to undertake stakeholder consultation to ensure it has a thorough understanding of the reasons why the company received the high "no" vote. We also suggest that at this stage the Chairman of the Board should become personally involved in the Remuneration Committee (if not already) to review the processes and realign remuneration with strategy and / or conduct a review of executive remuneration pay structures.

We do not support the Productivity Commission's recommendation that if the company's subsequent remuneration report receives a "no" vote higher than a prescribed threshold that all elected board members are required to submit themselves for re-election. This is because this part of the recommendation goes against generally-accepted governance principles.

Shareholders elect the directors of the board to act on their behalf in terms of determining the company's strategy, and this includes the remuneration strategy. Directors, in turn, have a fiduciary duty to shareholders to act in their best interests. If shareholders are not comfortable that a director, or the full board, is acting in their best interests, then they have the mechanism already in place not to re-elect the director when the director presents himself / herself for re-election.

Directors are required to submit themselves for re-election every three years. Accordingly, if shareholders do not believe the remuneration strategy approved by the board is in their best interests, it would take a maximum of three years for them to have the opportunity to remove the director from the board. Under the proposed "two-strikes" test, it would also be a three year period before shareholders would have the opportunity to remove the director from the board provided no EGM was held.

Appendix A – Overview of Walker's Good Practice Guidelines in respect of objectivity

The Walker review[1] proposed a voluntary code of conduct in relation to executive remuneration consulting in the UK. This review proposed five key areas being transparency, integrity, objectivity, competence and due care, and confidentiality.

For the purposes of providing further information in respect of our response to recommendation 10, which focuses on ensuring that remuneration advisors provide their advice direct to the remuneration committee or board, independent of management, we have outlined a summary of Walker's recommendations in respect of objectivity only.

Objectivity

Consultants should not allow conflict of interest or undue influence of others to override professional or business judgements. There should be clarity in identifying the client, establishing the role expected of the Consultant and agreeing the processes and protocols to be followed.

When the Consultant is appointed as a principal advisor to the Remuneration Committee, it is important to agree with the Chair of the Remuneration Committee and record, at the outset of the engagement, supporting protocols in order to safeguard objectivity. These are likely to cover information provision and the basis for contact with executive management.

In respect of illustrating how the objectivity requirement can be met, Walker also proposed good practice guidelines.

1. *A review of corporate governance in UK banks and other financial industry entities,* 16 July 2009.

Good Practice Guidelines – Objectivity

When the Consultant is appointed as principal Remuneration Committee advisor, there are a number of protocols and processes which should be established from the outset to ensure that the Consultant is able to provide best advice in a manner which meets the Remuneration Committee's requirements. These include:

- agreeing a process to ensure that the Consultant has sufficient information to provide advice in context (which may be achieved by providing for the Consultant to receive copies of all or most Remuneration Committee papers and minutes, not just those relating to matters upon which he or she is specifically being asked for advice);
- an agreement that the Consultant meets at least annually with the Remuneration Committee Chair in order to review remuneration issues and any implications of business strategy development and market change;
- clarity on the extent to which the Consultant should have access to and / or provide advice to management;
- confirmation of the process by which any information and recommendations relating to the CEO and other executives are to be communicated to the Remuneration Committee and the manner and extent to which such information and recommendations should also be communicated to executive management;
- agreement on the flow of papers and, in particular, whether draft papers may be sent to management to check facts and understanding of context prior to being sent to the Remuneration Committee Chair.

Contact details

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