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Regnan Submission to the Productivity Commission on the Regulation of Director and Executive Remuneration in Australia – 6th November 2009

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Australian Reward Investment Alliance

CATHOLIC Super

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1. Introduction

1.1. We are 10 institutional investors with a long-term perspective on financial markets and who collectively invest $19.1 billion in listed Australian companies as at 30th June 2009. We welcome the opportunity to provide comment to the Australian Government Productivity Commission (Productivity Commission) on its *Executive Remuneration in Australia, Discussion Draft* paper (Discussion Draft) released on 30th September 2009.

1.2. Regnan is a specialist governance adviser that since 2001[1] has undertaken research and engagement on ESG[2] issues including executive remuneration, on behalf of institutional investors. Regnan is owned by eight leading institutional investors, and at the time of this submission was retained by thirteen institutional investors with a mandate to proactively identify potential governance risks and engage investee companies in relation to these risks.

1.3. This submission reflects the views of the following organisations;

- ARIA,
- Catholic Super,
- Hermes – owned by and managed for the BT (British Telecom) Pension Scheme,
- HESTA Super Fund,
- NSW Local Government Superannuation Scheme,
- NTGPASS (Northern Territory Government and Public Authorities Superannuation Scheme),
- Vanguard Investments Australia,
- Victorian Funds Management Corporation,
- VicSuper, and
- Westscheme.

1.4. In March 2009, Regnan released a *Remuneration Reform Proposal* in accordance with its mandate from clients to contribute constructively to improved remuneration governance.

1.5. Regnan has since continued to contribute to the public debate, participating in the Productivity Commission's earlier consultation process on executive remuneration. Regnan has also participated in consultation processes with;

- Australian Government Treasury (Treasury) and a Senate Economics Legislation Committee (Senate Committee) regarding termination payment legislation,
- Treasury on Taxation of Employee Share Schemes (ESOPs), and

[1] Then as the BT Governance Advisory Service.
[2] Environmental, social and corporate governance.

- Australian Prudential Regulation Authority (APRA) on its Consultation Package on Remuneration.

1.6. Regnan commends the Productivity Commission for its comprehensive work in developing its recommendations.

1.7. We broadly support the Productivity Commission's recommendations put forward in the recently released Discussion Draft. In particular we view the recommendation to end the "no-vacancy rule", the establishment of a "two-strikes rule", and removal of "cessation of employment" as a tax barrier to deferred remuneration as important steps forward that, if implemented, will contribute to positive and constructive executive remuneration reform in Australia. If these recommendations are not adopted, we note that the opportunity for improved remuneration governance following the global financial crisis will have been lost.

1.8. Our submission focuses on executive remuneration only, and does not seek to comment on remuneration of non-executive directors. In addition, we have chosen to comment only on those recommendations we believe to be within our area of expertise.

2. Regnan's First Submission to Productivity Commission

2.1. Regnan submitted to the Productivity Commission in May 2009 commenting on the first Issues Paper on behalf of ten client organisations.

2.2. That submission identified significant remuneration quantum increases, combined with short-term remuneration structures, as creating a major misalignment between listed company executives and the long-term owners of those listed companies. It stressed that the remuneration practices leading to misalignment were not limited to the financial sector, and extended across all sectors.

2.3. The abovementioned misalignment is of concern due to the significant capital flows arising from superannuation contributions made by the Australian public that benefit listed companies, and the potential for these capital flows to be diverted into less economically productive assets (such as cash or housing) should the community lose trust and confidence in the capital markets system. There was also concern because executive remuneration structures that promote short-term cash rewards risked executives being focussed on the short-term and potentially ignoring the long-term consequences of their decisions.

2.4. Regnan submitted that a "one size fits all" approach to executive remuneration was not appropriate, and that company boards should retain flexibility to determine specific remuneration arrangements. However, in line with Regnan's Remuneration Reform Proposal, the following remuneration principles were strongly advocated;

- Deliver a significant proportion of executive rewards in the form of equity,

- Defer equity rewards by requiring vesting over the long-term, which we expect to be around five to ten years, and

- Vesting provisions applying to equity-based remuneration components should continue after cessation of employment to ensure alignment of executives with long-term owners of a company.

3. Regnan's Other Remuneration Work

3.1. Regnan has supported the government's move to tighten the legislation governing approval of termination payments to senior executives.

In doing so Regnan urged that the post-implementation review of the termination payments legislation look for evidence of whether the new legislation has caused material unintended consequences (such as artificial pressure inflating base salaries) or has restricted boards in a manner that materially reduces their ability to attract executive talent. If the post-implementation review were to find compelling evidence that these risks have been realised, Regnan has advocated that the threshold requiring shareholder approval lift from 12 months' base salary to 24 months' base salary. For those termination payments between 12 months' and 24 months' base salary, they should then be subject to an "if not, why not" regime of explanation regarding why such a termination payment has been made.

3.2. Regnan has strongly advocated Treasury amend proposed taxation legislation by removing the "cessation of employment" taxing point in respect of deferred remuneration. We have also advocated Treasury raise the maximum time over which tax may be deferred on equity-based remuneration from the proposed seven years, to at least ten years (as it was previously) in order to allow better alignment between executives and long-term owners (who invest for well beyond seven years in a company).

We understand that the Australian Government is proceeding with legislation that maintains taxation of equity-based remuneration upon cessation of employment despite advocacy by APRA[3], the Productivity Commission, Regnan and the Walker Review[4]. This is materially detrimental to the interests of long-term investors such as superannuation funds.

3.3. Regnan has supported APRA's proposed extensions to the prudential standards on governance and corresponding guidance (the Consultation Package on Remuneration), noting that the principled approach taken is consistent with the Financial Stability Forum's (FSF) principles for sound compensation practices, both Australian Stock Exchange's (ASX) and Australian Institute of Company Director's (AICD) guidelines, and Regnan's own

[3] Paragraph 44 on page 10 of APRA's Prudential Practice Guide 511 – Remuneration, advises against all deferred payments automatically vesting upon an employee leaving a regulated institution.

[4] Recommendation 33 on page 98 of the Walker review of corporate governance in UK banks and other financial entities, advocates deferred incentive payments, and recommendation 34 also on page 98 advocates that cessation of employment should not result in an acceleration of deferred rewards.

Remuneration Reform Proposal. In particular, APRA's advocacy of post-departure vesting[5] is crucial to achieving alignment between executives and long-term owners and is consistent with not only Regnan's own proposal but also the Walker Review.

4. Response to Productivity Commission Recommendations

4.1. Board Capability Recommendations

4.1.1. Company boards should include directors who represent a diverse range of backgrounds, ethnicity, age and gender. Without diversity, shareholders risk entrusting their capital to a board that lacks the range of perspectives necessary to sufficiently challenge management, and to make more thoroughly informed and robust decisions on remuneration and other matters.

4.1.2. We support Draft Recommendation One aimed at ending the 'no vacancy' rule test.

4.1.3. If a candidate receives support from 50% or more of shareholders voting, they should be entitled to represent shareholders on the board. This may potentially improve the pool of candidate directors.

4.2. Conflicts of Interest Recommendations

4.2.1. We offer qualified support to Draft Recommendation Two, while advocating it apply to the S&P/ASX200 instead of the S&P/ASX300.

4.2.2. Enforcing majority independence of remuneration committees via a new listing rule is consistent with accepted good governance practice, as evidenced by the Australian Securities Exchange's (ASX) Corporate Governance Council recommendation that a remuneration committee comprises an independent chair and a majority of independent directors.[6]

4.2.3. For reasons of good governance, we believe it appropriate for the remuneration committee of an S&P/ASX entity to comprise solely non-executive directors. We do recognise that there is a need for a chief executive officer to contribute to remuneration decisions regarding other senior executives. The chief executive officer should attend committee meetings in an invited capacity, while being excluded from the meeting when independent directors discuss the chief executive officer's own remuneration. The ASX Corporate Governance Council suggests that a remuneration committee's charter should clearly set out the procedures relating to

[5] Paragraph 44 on page 10 of APRA's Prudential Practice Guide 511 – Remuneration, advises against all deferred payments automatically vesting upon an employee leaving a regulated institution.

[6] Page 35 of the Corporate Governance Principles and Recommendations – 2nd Edition, released by ASX Corporate Governance Council in August 2007.

non-committee members to attend meetings[7], and these procedures should apply to the chief executive officer.

4.2.4. We question the scope of the new listing rule, considering the likelihood that the S&P/ASX300 will contain smaller entities in an exploration/development phase that typically have smaller numbers of directors, and in some cases a board size of only three. We therefore advocate the new listing rule should instead apply to entities within the S&P/ASX200, and that the "if not, why not" recommendation from Draft Recommendation Three apply to ex-S&P/ASX 200 entities.

4.2.5. We offer qualified support to Draft Recommendation Four. We agree with prohibiting executives identified as key management personnel from voting on a company's remuneration report. However, we advocate that the voting prohibition not extend to non-executive directors (and their associates).

4.2.6. Company executives identified in a company's remuneration report face a clear conflict when being asked to endorse their company's own remuneration practices. However, we do not believe this conflict extends to non-executive directors given their remuneration is funded from a fixed pool of money which must receive shareholder approval (and on which non-executive directors themselves may not vote).

4.2.7. We support Draft Recommendation Five's suggestion that the Corporations Act 2001 should prohibit all company executives from hedging unvested equity-based remuneration and equity based remuneration subject to holding locks.

4.2.8. Hedging of unvested equity remuneration or vested equity remuneration subject to holding locks breaks the risk/reward connection between executives and shareholders (because it limits the economic risk otherwise faced by an executive[8]) and thus defeats the purpose for which such remuneration was intended; alignment. The importance of maintaining this connection is already recognised by the ASX Corporate Governance Council's guidelines for executive remuneration packages[9], and thus Draft Recommendation Five acts to further strengthen good governance practice.

4.2.9. With regard to Draft Recommendation Six, we advocate an alternative approach to preventing key management personnel and all directors (and their associates) from

[7] Page 35 of the Corporate Governance Principles and Recommendations – 2nd Edition, released by ASX Corporate Governance Council in August 2007.

[8] As the ASX Corporate Governance Council Guideline 3 in Box 8.1: Guidelines for executive remuneration packages states in regard to equity-based remuneration, "The terms of such schemes should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes".

[9] Page 36 of the Corporate Governance Principles and Recommendations – 2nd Edition, released by ASX Corporate Governance Council in August 2007.

voting undirected proxies on remuneration reports and any other remuneration-related resolutions.

That alternative approach is a mandated change to the format of the proxy form used by companies in a Notice of Meeting, which requires that the board's recommendation (where one exists) on each resolution be printed next to the corresponding voting boxes. Also required should be a clear message printed above the voting boxes, informing shareholders of the consequences of casting an undirected proxy. This alternative approach maintains the current flexibility for shareholders to support the board's decision via an undirected proxy, while minimising the risk that shareholders unintentionally support the board's decision (on remuneration or any other resolution) by casting an undirected proxy.

4.2.10. We support Draft Recommendation Seven, which recommends that the Corporations Act 2001 be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration-related resolutions.

4.2.11. Not casting a directed proxy is to deny a shareholder's right to vote on a resolution. For this reason, we believe Draft Recommendation Seven should also apply to all resolutions.

4.3. Disclosure Recommendations

4.3.1. We agree with Draft Recommendation Eight, which advocates mandatory use of plain English summaries of remuneration reports.

4.3.2. The Commission uses the term "actual levels of remuneration". Regnan believes that this needs further defining. We support the disclosure of all remuneration that has been realised or become realisable (i.e. options that have vested but not exercised) during the reporting period. The realisable value of options is the intrinsic value, i.e. between the market price and the exercise price on the day a benefit vests to the executive.

4.3.3. Further, we support the disclosure of the "fair value" of remuneration paid or granted during the reporting period.

4.3.4. The current accounting standards require the amortization of "fair value" over the performance period. This creates confusion for readers of remuneration reports, as there is often no correlation between the accounting value and the remuneration actually received by an executive or what has been granted during the year.

We believe that remuneration should instead be disclosed on a fair value basis, as well as on a realised/realisable basis, as this will provide investors with a truer representation of remuneration received by executives. The specifics of how such an approach should be taken will be addressed in a separate submission focusing on a re-write of section 300A of the Corporations Act 2001.

4.3.5. We do not support the additional requirement to disclose shareholdings of individuals named in the report, as AASB124 already captures this. Disclosure of two identical tables in an annual report is superfluous. We believe that the correct place for this table is the remuneration report.

4.3.6. We support Draft Recommendation Nine, which recommends that Section 300A of the Corporations Act 2001 be amended to reflect that individual remuneration disclosures be confined to key management personnel, and that the additional requirement for the disclosure of the top five executives should be removed.

4.3.7. We support Draft Recommendation Ten, which suggests that ASX listing rules should require that, where an S&P/ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.

4.3.8. The alternative, whereby a remuneration consultant's advice to a company board may be subject to the influence of management, presents clear conflicts for which we can see no justification.

4.3.9. However, we note that without transparency, shareholders may continue to lack confidence in the independence of remuneration advisers. Draft Recommendation Ten should therefore also require;

- Disclosure of the advisor (support for Draft Recommendation Eleven),
- Disclosure of policies to address conflicts of interest, and
- Disclosure of other work undertaken by the advisor, the amounts paid and the board's role in approving such work.

4.4. Remuneration Principles Recommendations

4.4.1. We support for Draft Recommendation Thirteen, while advocating the seven-year limitation on deferred equity rewards be removed.

4.4.2. We are strongly in favour for removal of the cessation of employment as a taxing point for equity-based remuneration. Our first submission to the Productivity Commission on executive remuneration outlined our rationale for removal of this taxing point; to allow alignment of executives with their legacy via deferred equity-based remuneration (in the same way shareholders are exposed to their legacy).

4.4.3. We do not agree with placing a seven-year limit on the length of time over which tax may be deferred on equity-based remuneration. If a seven-year limit were implemented (as opposed to the previous ten-year limit), companies may face a significant barrier to implementing executive remuneration structures that generate alignment over longer-term periods, such as five to ten years as we have previously advocated. Given the typical long-term duration of some company strategies (e.g. mining company site strategies), and the typical term to maturity of superannuation investments (which can run to decades), even a ten-year limit risks a short-term focus by management. Therefore, we advocate the Productivity Commission revise Draft Recommendation Thirteen by not imposing a ceiling on the length of time over which equity-based remuneration may be deferred. Otherwise, the Productivity Commission should replace the reference to a seven-year time limit with the previous ten-year limit.

4.4.4. We understand that the Australian Government is proceeding with legislation that will maintain taxation of equity-based remuneration upon cessation of employment. Cessation of employment as a taxing point for equity-based remuneration is contrary to recommendations from APRA, the Walker Review, Regnan's Remuneration Reform Proposal and the Productivity Commission's own Draft Recommendation Thirteen, and is not consistent with the interests of sound risk alignment or long-term investor interests (such as superannuation funds). We understand Treasury has drafted the above-mentioned legislation in response to concerns about lost tax revenue. However, reporting requirements also introduced as part of the new legislation governing taxation of employee share schemes[10] ensure the Australian Tax Office has means to enforce individuals' tax obligations on equity-based remuneration that vests after cessation of employment. The value of risk alignment should always outweigh short-term revenue considerations.

4.5. Shareholder Engagement Recommendations

4.5.1. We support Draft Recommendation Fourteen, which recommends that the Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments, consistent with the recommendation issued by the Parliamentary Joint Committee on Corporations and Financial Services in 2008.

4.5.2. We support the first section of Draft Recommendation Fifteen. This suggests that the Corporations Act 2001 be amended to require that where 25% of shareholders voting, vote against a company's remuneration report, the board be required to report back to shareholders in the subsequent remuneration report explaining how

[10] Sections 1.49 to 1.54 on pages 12-13 of Chapter 1 of the Explanatory Materials for the Tax Laws Amendment Bill 2009 & Income Tax Bill 2009, bundled as part of the Exposure Draft Package.

shareholder concerns were addressed, and, if they have not been addressed, the reasons why.

4.5.3. It is reasonable to expect a board to hold itself accountable to shareholders, and respond to shareholder criticisms regarding remuneration in cases where a company has received a significant 'against' vote on a remuneration report. We believe 25% of shareholders voting "against" a remuneration report is an appropriate threshold. Whilst there are criticisms that 25% represents only a minority of shareholders, the consequence of this first strike (reporting to shareholders on how their concerns have been addressed) is appropriate for such a threshold.

4.5.4. We also support the second section of Draft Recommendation Fifteen. In doing so, we advocate that the threshold of 'against' votes for the second strike be set at 50% of shareholders voting.

4.5.5. Given that the consequence of a company receiving a 'second strike' is more material for a company board (re-election versus reporting to shareholders), it is appropriate that a majority of shareholders be required to vote against the remuneration report in the second instance in order to trigger the consequences of a second strike.

4.5.6. We have considered that increasing the consequences of voting against a remuneration report, such as implementation of the second strike rule, may make institutional investors less likely to vote against and thus reduce the effectiveness of the non-binding vote. However, it is expected and appropriate that investors would apply careful scrutiny when deciding to vote against the remuneration report for a second time and risk the re-election of the whole board.

4.5.7. Even if instances of a second strike occurring are few, it is anticipated that the mere threat of the consequences of a second strike will be enough to drive further company engagement with shareholders on remuneration. A potential downside of setting the second strike threshold any lower than 50% may in fact be that this amplification of remuneration matters is raised to an inappropriately high level in the context of directors' other duties.

4.5.8. We agree with the Productivity Commission's decision to leave Listing Rule 10.14 unchanged. Listing Rule 10.14 is already sufficiently effective at preventing widespread dilution of shareholder equity.

4.5.9. Were Listing Rule 10.14 changed to include all equity issuances, we would hold the following concerns;

- It may drive remuneration away from equity-based incentives to cash-based incentives, thus reducing alignment between executives and the interests of long-term company owners,
- Directors have the information at hand to determine performance hurdles and shareholders do not. The rule would in effect remove an operational domain away from the board,
- Shareholders already have two tools to use if they are not happy with performance hurdles;
  - Non-binding vote on the remuneration report (which has proved to be effective), and
  - Voting against directors (a tool we believe is not utilised to the degree it ought to be).
- Such a rule would only involve a vote on a particular component of pay (micromanagement by shareholders) and we question the usefulness of such an action,
- Such a rule would also apply to equity-based short-term incentives and therefore make it impractical to operate short-term equity-based incentive plans if shareholder approval is required for any equity grant. This could potentially result in all short-term incentives being cash based.