BRIEFING PAPER

to

PROPOSED AMENDMENT OF SECTION 300A

Background

Section 300A was inserted into the Corporations Act in 1998.

Its genesis was a consequence, and followed a period, of lobbying on behalf of the investment community by the Australian Investment Managers' Association (one of three investment industry bodies now consolidated into the Investment & Financial Services Association ("IFSA")) and Corporate Governance International Pty Ltd (now part of the international Glass Lewis proxy advisory group and known as CGI Glass Lewis Pty Ltd).

That lobbying was for the introduction of six governance-based reforms, which ultimately (courtesy of a Senate majority vote led by the Labor Party and supported by other non-Liberal government senators) led to their insertion into the Corporations Act in 1998[1].

One of those six reforms was section 300A. The other five reforms included, for example, the requirement of publicly listed companies incorporated in Australia to give a minimum 28 days' notice of annual or other general meetings under section 249HA and to disclose to the Australian Stock Exchange Limited (now known as the Australian Securities Exchange Limited) ("ASX") the proxy voting results of each resolution submitted to shareholder vote under section 251AA of the Corporations Act.

The purpose of the architects of the six 1998 reforms was to oblige all ASX listed Australian incorporated companies (which then comprised, and continue to comprise, most of the entities listed on the ASX) to adopt a number of disclosure and other practices that would enable public, and especially institutional, investors to better fulfil the corporate governance role of shareholders in those companies.

Corporate Governance and Remuneration

Remuneration is a core issue in the governance of those companies because it determines how the spoils of those companies are divided between those that work in the companies (and especially those at the top who largely determine the remuneration of those that work in the companies) and those who own the equity capital of those companies (the beneficial shareholders or shareowners).

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[1] Previous lobbying of the ASX to insert these six governance-based reforms into the ASX Listing Rules so that they would apply to all ASX listed entities was unsuccessful.

Those two groups are often referred to in governance literature as the agents (board and top management) and their principals (the shareowners). As in any agency, there is an inherent conflict of interest between the groups, with each interested to maximize their own share of reward. That conflict is exacerbated in the case of ASX listed companies by the capacity of board and top management to set their own remuneration subject only to the limited powers of the shareowners to monitor and control that remuneration, which is their governance role.

Purpose of s300A

In the case of s300A (as with the other 1998 reforms), the architects sought to improve the capacity of shareowners to carry out their governance role by providing them with better tools to do so. These tools were in the form of enhanced and more useful disclosure of remuneration coupled with the discipline on the company of a non-binding shareholder vote on an annual remuneration report prepared by the company incorporating that enhanced disclosure.

Whilst s300A has been somewhat corrupted from its original message and purpose by subsequent tinkering with its content (see below), its architects correctly anticipated that the reform would lead to both agents and principals doing an improved job in the key remuneration area.

The enhanced disclosure introduced in 1998 was essentially of two complementary types:

1. The first was intended to be disclosure of the board's[2] remuneration policy for the year under report, including, in particular, the relationship of that policy to the company's performance. At the time, the disconnect in many cases between a company's remuneration practices and its performance was seen by the architects to be a major disclosure issue requiring improvement.

2. The second was intended to be disclosure of what the company actually paid its key executives for the year under report. This was so that, inter alia, sophisticated investors (such as institutions that are themselves remunerated and responsible for the prudent investment of their clients' or beneficiaries' money) could better assess whether the company's professed (disclosed) remuneration policy was actually borne out in the executive's pay packet.

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[2] The increasingly chequered history of s300A was not helped by its introduction in 1998 with an important typographical error - the architects' expression "the board policy" in their submitted draft being replaced in the section, when enacted, by the words "the broad policy". That expression immediately led to significant confusion over its meaning.

Subsequent tinkering with s300A

In the intervening years since 1998, s300A has undergone substantial development, which has not remained true to its original purpose explained above.

In particular, it has been corrupted by linking it to accounting and other standards so that what has to be disclosed is both highly complex and, hence, difficult for even sophisticated investors to grasp and, especially in the case of equity based long term incentives ("LTIs"), totally fails to provide an accurate and meaningful disclosure of what the executive actually received for the year under report.

This is because the linking to accounting standards methodology requires equity based LTIs to be amortised over the vesting period so that the amount disclosed for the year under report is a meaningless (in term's of the section's original purpose) amalgam of a number of years' amortised grants.

More recently, the picture has been further clouded in the case of certain short term incentives ("STIs"). This is because, with the development of best practice toward paying some STI in the form of equity subject to delayed vesting (e.g. for retention purposes), the same accounting standards amortisation methodology has to be applied to their disclosure.

Getting s300A Back to Basics

The solution is to rewrite s300A so that it gives effect to its original purpose and is clear and readily understandable – or, at least, to the executives and directors of the publicly listed companies incorporated in Australia and to the institutions and other sophisticated investors that invest in them.

The Joint Submission of Allens Arthur Robinson, CGI Glass Lewis, Guerdon Associates and Regnan Governance Research & Engagement to the Productivity Commission's Executive Remuneration Inquiry seeks to achieve this.

The following is an explanation of its key elements.

Structure

The proposed simplified section 300A and associated regulations submitted to the Commission will only apply to disclosing entities which are companies and will not cover other entities such as managed investment schemes.

The proposed simplified section 300A and associated regulations is structured with very basic concepts in the legislation itself (s300A) and with its real meat in a proposed amendment of the relevant corporations regulation 2M.3.03.

This is designed to facilitate further amendment (i.e. of the regulation rather than requiring amendment of the section in the legislation) in light of ongoing experience.

Future Amendment

While on the subject of further amendment, in order to guard against the risk of further corruption of the legislative provisions, it is recommended that an expert panel is constituted under the Productivity Commission's auspices to monitor the ongoing operation of s300A, including regulation 2M.3.03, and to be involved in any subsequent amendment thereof.

The authors of the Joint Submission will be willing to serve on such a panel.

Section 300A

The simplified section 300A requires Australian incorporated companies to include in their directors' report for the financial year a separate section called the remuneration report that includes two types of disclosure:

1. The first is a plain English summary of the remuneration policies for key management personnel as defined in the accounting standards ("KMP") that discusses the matters prescribed in the regulations (in fact, regulation 2M.3.03); and
2. The second is the (actual) remuneration for each member of KMP in the format prescribed in the regulations (again, in fact, regulation 2M.3.03).

There is also a sweeper provision requiring disclosure of all other information that may be prescribed.

It will be seen that the structure of the amended section harks back to the purpose of the original 1998 section discussed above.

In the case of the remuneration policies for KMP, the companies will be obliged to address each of the specific matters (prescribed in the regulations) so that there is consistency between companies in the policy matters addressed in their remuneration reports. This proposed requirement is in light of experience with remuneration reports produced by companies to date, which do not always address matters that should be addressed in order to properly inform shareowners on the company's remuneration policies.

In the case of the (actual) remuneration of KMP, the companies will be obliged to disclose that information in a specific format (prescribed in the regulations) again so that there is consistency between companies in that disclosure in their remuneration reports. This proposed requirement is also in light of experience with remuneration reports produced by companies to date, which employ a variety of formats that sometimes require considerable sleuthing to hunt down the information and other times can omit information that should be disclosed in order to properly inform shareowners on the (actual) remuneration of KMP.

Overall, requiring consistency of disclosure of both remuneration policy matters and the (actual) remuneration of KMP in a standard format will substantially simplify the work of investors in grasping the relevant information for each company and also in comparing that information across relevant comparator companies.

The utility of this approach is reflected in the work of CGI Glass Lewis in analysing remuneration reports of listed companies for their institutional clients; those analyses are constructed in a similar consistent manner and format, thereby facilitating the work of their clients in understanding the remuneration policies and (actual) remuneration of KMP in their various investee companies.

Please see the earlier joint submission of CGI Glass Lewis and Guerdon Associates for the reason why the remuneration report disclosure should be limited to KMP, which is also consistent with the draft recommendation of the Commission in its draft report.

Regulation 2M.3.03

This amended regulation prescribes:

1. In sub-regulation (1) the matters to be discussed in the plain English summary of the company's remuneration policies, and
2. In sub-regulation (2) the (actual) remuneration of KMP in two categories:
   - "Realisable" remuneration for the financial year, and
   - Grants received for the financial year.

Plain English summary

The regulation requires the plain English summary to give the reader an informed understanding of the company's remuneration policies for KMP and to discuss specified matters in a specified order.

The specified matters are based on the Productivity Commission's draft finding 1 in relation to well-conceived remuneration policies and are listed in light of experience with problematic remuneration reports produced by companies to date – i.e. will ensure that key matters are addressed.

The specified order will provide consistency of presentation, which again will assist the reader both with each company and in comparison with other comparator companies.

Realisable remuneration

Realisable remuneration means the fixed remuneration and the fair value of any other incentive, termination or other benefit that vests in the year irrespective of when it was granted – i.e. what the executive actually received during the year.

The regulation goes on to require a break up of key elements and other information to enable shareowners to obtain a meaningful understanding of what the executive actually received during the year, the mix between different types of remuneration and the types of conditions that were attached to that remuneration.

Grants received

This type of disclosure will provide investors with a better understanding of the various elements of remuneration that were granted to the executive during the year, in the form of both remuneration that was granted and vested in the year and remuneration that was granted during the year but will not vest until a later year, in the latter case at a defined "actual value".

Again, this type of disclosure will provide investors with a better understanding of the different elements of remuneration granted to the executive during the year, including the actual value of grants that will not vest until a later year and, thereby, the relative values or break up between fixed remuneration and other types of remuneration for the year, including LTI grants subject to one or more performance or other vesting hurdles.

Total shareholding

Finally, the regulation requires the total shareholding of each KMP to be disclosed in the remuneration report.

Monitoring and enforcement

To date the corporate regulator, ASIC, has neither monitored nor enforced compliance with section 300A. The reason given has been lack of resources and other priorities.

Given the comments above on the special importance of remuneration from a governance perspective, it is particularly important that all companies are required to comply with the law on remuneration and ASIC should police compliance accordingly.

The Productivity Commission should address this current practical problem of lack of monitoring and enforcement in its final report.