CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

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Executive Pay Discussion Paper
Business Environment
Department for Business, Innovation and Skills
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UNITED KINGDOM

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To whom it may concern

Executive remuneration

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the discussion paper, *Executive Remuneration* (the paper), exploring questions of the role of shareholders and remuneration committees in the process of setting pay and examining links between executive remuneration and company performance. CSA notes that the paper refers to the regulatory framework for executive remuneration in other jurisdictions, including Australia. CSA believes that the Australian regulatory and governance framework provides an excellent comparative viewpoint from which to engage in this review.

Chartered Secretaries Australia (CSA) is the independent leader in governance and risk management in Australia. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. Our Members are all involved in governance, corporate administration and have a thorough working knowledge of the operations of the financial markets, the needs of investors and the corporations law.

General comments

In public listed companies, responsibility for supporting engagement with shareholders on remuneration issues, monitoring changes in governance policies and issues of concern to shareholders in relation to remuneration and preparing the remuneration report for issue to shareholders frequently sits with the company secretary. The company secretary does not, however, make decisions concerning the levels or structure of executive remuneration: this rests with the board. Company secretaries drive and advise on best practice in governance; champion the compliance framework to safeguard the integrity of the organisation; promote high standards of ethical and corporate behaviour; and bridge the interests of the board or governing body, management and stakeholders. Our Members are uniquely positioned to provide independent, expert commentary on the governance issues attached to director and executive remuneration.

Some of our Members also work in dual-listed companies, including those also listed in the United Kingdom (UK), and thus have experience of the regulatory and governance regimes operating in other jurisdictions. Those Members will be directly affected by any regulatory change brought about by this consultation.

In addition, Australia has examined the regulatory and governance framework relating to remuneration in some detail over the past few years. In 2009, the Australian Government tasked the Productivity Commission to conduct an inquiry into the levels and structure of remuneration to respond to community and political concern with these matters. The government announced in 2010 that it would implement the majority of the recommendations contained in the Productivity Commission's report.[1]

In its final report, having examined a number of alternative measures proposed by participants, the Productivity Commission was convinced that the way forward was not to bypass the central role and responsibility of boards in remuneration-setting.

It concluded that the only practicable means for the many thousands of diverse shareholders of a public company to achieve a remuneration structure that promotes the company's long-term interests is for them to ensure that they have an able and properly motivated agent — the board.

The Productivity Commission considered that the more appropriate and proportionate response was to improve corporate governance and enhance the effectiveness and credibility of boards, as well as to make boards more accountable in relation to pay setting, taking into account the need to minimise potential costs and the scope for unintended consequences.

CSA firmly supports the Productivity Commission's recommendation that remuneration frameworks, including the structuring of incentive components, remain a matter for the board and that boards should make every effort to explain their remuneration decisions and shareholders should have the capacity to hold directors accountable for their decisions on remuneration.

In 2010, legislation was introduced in Australia requiring shareholder approval of termination payments to executives of more than one year's base salary.

In 2011, legislation was introduced based on the recommendations of the Productivity Commission. The Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011, which took effect on 1 July 2011 introduced, among other changes:

- a 'two-strikes' rule for the non-binding vote on the remuneration report and restrictions on the ability of key management personnel (KMP — directors and senior executives) to vote on the remuneration report. The *Corporations Act 2011* was amended to provide that if 25 per cent of the votes cast at an AGM oppose the adoption of the remuneration report, and shareholders make comments at the meeting on the report, then in the following year the board must report on any proposed responses to those comments, or explain why it does not propose any response. If 25 per cent of the votes cast at two consecutive AGMs oppose the adoption of the remuneration report, then at the second AGM the company must give shareholders the option (if 50 per cent or more of votes cast are in favour of a 'spill') to require that the entire board (except the managing director) stand for re-election at a further general meeting. This meeting must take place within ninety days. Furthermore, the Act prohibits the KMP whose remuneration is disclosed in the remuneration report (and their closely related parties) from voting on the adoption of the report and on the resolution to determine whether a 'spill' meeting must be held.

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[1] Productivity Commission, Inquiry Report, *Executive Remuneration in Australia*, No. 49, 19 December 2009, Productivity Commission

- new requirements affecting remuneration consultants — in remuneration reports for financial years commencing 1 July 2011, listed companies must report on the remuneration consultants they use to provide ‘remuneration recommendations’ relating to KMP; what other services they provide; the nature of the advice provided and the cost; and the remuneration consultants engaged by companies must be retained by and report to the board as a whole, or the remuneration committee.

That is not to say that the statutory developments in Australia described above are without criticism or have not resulted in unintended consequences. We have already seen the ‘two-strikes’ mechanism be used to create instability within a company rather than be used to opine on that company’s remuneration practices.

There are also practical difficulties in implementing the rules relating to the use of remuneration consultants, including questioning the ability of management to receive remuneration advice (independent of the board’s) on designing incentive schemes to present to the remuneration committee/board to review. There are also practical difficulties with the legislation requiring shareholder approval of termination payments to executives of more than one year’s base salary for those organisations with subsidiaries and in particular with subsidiaries in different jurisdictions — the devil really is in the detail and any statutory response must be properly consulted on and the resulting draft legislation carefully considered.

Our comments on the specific questions raised in the paper are made within the context of these changes to the regulatory framework in Australia in relation to executive remuneration and our Members’ role in providing a bridge between the interests of directors and shareholders.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

Role of shareholders

1. Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?

There are numerous practical difficulties in making the vote on the remuneration report binding, including that:

- the remuneration report deals with events that have already occurred — it is not clear what a negative binding vote in respect of past events would mean, for both the company (in terms of Pay As You Go liability) and the individual (in terms of certainty of pay and consequences of expenditure)
- if remuneration decision making is removed from the board, there may be ambiguity as to who is accountable for the performance of executives — this would be a governance quagmire
- remuneration reports are complex, and the shareholder vote is binary
- the remuneration report covers a number of different aspects of remuneration including the chief executive, other senior executives and non-executive directors, as well as the operation of salary, short-term incentives and long-term incentives. There is no way to determine which particular aspect might have lead to a no vote or what remedial action would be required to address a no vote
- boards may find that they are unable to recruit and retain executives with the necessary skills and talent due to remuneration restraints, that is, they are not in a position to finalise a contract when recruiting
- in Australia, directors have a fiduciary and statutory duty to act in the best interests of the company as a whole (similar to the UK statutory duty to promote the success of the company). Shareholders have no such fiduciary duty.

CSA is of the view that a binding vote on the remuneration report would inappropriately blur the line between owners and managers to the detriment of the company.

In Australia, as in the UK, the non-binding shareholder vote on the remuneration report has provided, since its inception, an opportunity for shareholders to hold boards accountable for their decisions on remuneration. CSA supports shareholders being able to hold a board accountable for their remuneration decisions, including in response to feedback from shareholders through votes on the remuneration report. Shareholder engagement is central to good governance. Both institutional and retail investors in Australia have noted that the introduction of a non-binding shareholder vote on a company's remuneration report was one of the single biggest catalysts for improved levels of engagement between shareholders and company directors.

The introduction of the 'two-strikes' rule in Australia in 2011 has not provided shareholders with the responsibility to set executive remuneration through a binding vote. Directors remain responsible to manage the CEO and executives in terms of attracting and motivating them through remuneration practice. Rather, if directors are recipients of shareholder dissatisfaction with their decisions on executive remuneration, and if shareholders believe that directors have failed to respond to their concern and express that through the non-binding vote in two subsequent years, shareholders can 'spill' the board at a special meeting in the second year.

CSA Members note that in the UK, annual re-election of directors is recommended. If shareholders do not support the board's decision on remuneration, the remedy is already available to those companies' shareholders to hold the directors accountable on an annual basis.

2. Are there any further measures that could be taken to prevent payments for failure?

In 2011 the Australian Government issued a consultation paper on the feasibility of the clawback of executive remuneration. CSA agrees that mechanisms to facilitate the recovery of amounts paid to executives based on financial statements subsequently found to be materially misleading are in the best interests of shareholders. It is appropriate commercial practice for a company to negotiate such an outcome and reflects good corporate governance. CSA is of the view that legislative prescription is not required to facilitate such recovery and may be undesirable and counter-productive. While legislation appears to be a holistic solution, with a clear enforcement capacity, it is an inflexible approach that provides a one-size-fits-all solution that is not appropriate to apply to all companies.

The government recognised, in its consultation paper on clawback in relation to executive remuneration, that Australian governance frameworks are very sound and a legislative approach may not be the optimal one. In October 2011, the Australian Government noted that a number of submissions to the consultation process highlighted concerns with the workability of a legislative approach to clawing back remuneration.[2]

CSA is of the view that the clawback of executive remuneration is best dealt with in the employment contract between an executive and the company, with directors accountable for their decision through disclosure to their shareholders whether such contractual arrangements are in place.

CSA also notes that, in the UK, the annual re-election of directors already provides the shareholders of some companies with the power to hold directors accountable if they are dissatisfied with decisions concerning remuneration.

3.What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

CSA notes that including shareholder representatives on boards is counter to the system of governance operating in both Australia and the UK. As in the UK, Australia subscribes to the unitary board model and does not follow the two-tier board model operating in Europe.

CSA notes that companies legislation, in Australia and other common law countries, is very clear as to the division of responsibilities in companies. The business of a company is to be managed by or under the direction of a board of directors appointed by and accountable to the shareholders, and the directors exercise all powers of a company except those that are required to be exercised in a general meeting.

Companies legislation recognises the role that directors play as agents for shareholders, with their fiduciary duties to act in the best interests of the company as a whole encompassed by statute and common law. Directors have responsibility to take decisions concerning the company on a wide range of matters, and decisions on those issues are not taken in isolation. Remuneration is only one element in that range of decision making. Involving shareholders in remuneration decisions would be to isolate one element of decision making from its broader context.

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[2] The Hon David Bradbury MP, Parliamentary Secretary to the Treasurer, Redefining *Executive Remuneration and Performance*, Keynote Address to IQPC, Remuneration and Reward Conference, Melbourne, 19 October 2011. In his speech, he also noted that: ‘The new global standards on pay in the financial sector require that any unvested performance-based component of remuneration must be able to be reduced or eliminated if long-term performance objectives are not realised’.

CSA Members are of the view that including shareholder representatives on nominations committees raises questions, as follows:

- it is to be assumed that shareholders would elect a representative, which is an illogicality, as they already elect directors to represent their interests
- shareholders have no fiduciary duty under the companies legislation, but once elected they would hold a fiduciary duty to act in the best interests of the company as a whole (in Australia, with a similar duty in the UK). It is important to clarify that the legislation does not state that directors must exercise their powers and discharge their duties in the best interests of shareholders, although it appears that case law has tended to grant primacy to shareholders' interests. It foregrounds the best interests of the company, which generally coincide with the best interests of shareholders. Any shareholder elected to the board is not, therefore, in a position to represent only the interests of shareholders rather than the interests of the company as a whole, as this would represent a conflict of interest.

CSA is a founding member of the Australian Securities Exchange (ASX) Corporate Governance Council and a strong supporter of the Council's *Corporate Governance Principles and Recommendations*.[3] CSA notes that the guidelines state that:[4]

> The board should be of a size and composition that is conducive to making appropriate decisions. The board should be large enough to incorporate a variety of perspectives and skills, and to represent the best interests of the company as a whole rather than of individual shareholders or interest groups.

Role of remuneration committees

4. Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

CSA notes that the board has ultimate responsibility for examining the selection and appointment practices of the company, regardless of whether a nominations committee exists. It is essential that the majority of directors be independent, non-executive directors with the skills necessary to add value to board decision making.

A key responsibility of the board is to develop a skills matrix for the board in order to plan for board renewal. It also has a responsibility to develop a process for selecting committee members and to set up appropriate board committee charters so that a committee may bring in professional advisers as required.

At present there is sufficient flexibility for boards, or remuneration committees, to appoint directors with very specific professional backgrounds, but they choose not to do so, as the reliance on the particular professional skills of one director for specific decisions is not only counter to the unitary nature of the board that takes decisions as a whole, but also introduces personal liability issues, given that all directors will be held accountable for any decisions of the board and directors have a duty to independently consider any decision that a board may take. Should the board or any of its committees require access to further expertise on a topic,

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[3] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments*, 2nd Edition, 2010, p 19

[4] Ibid, pp 18-19

directors seek professional advice. It is for the directors to then independently review that advice and make decisions.

Any committee member is a member of the board with a fiduciary duty to act in the best interests of the company as a whole, with the skills required to provide oversight and monitoring capacity on a range of decisions, of which remuneration is only one element. It is the board skills matrix which will reveal the ‘gaps’ in the skills and experience of the directors on the board.

5. Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?

In 2010, in order to address concerns relating to conflicts of interest, or perceptions of conflicts of interest, ASX amended the Listing Rules to introduce a requirement that entities included in the S&P/ASX 300 Index must have a remuneration committee that is comprised solely of non-executive directors. Research by ASX revealed that top 300 ASX listed entities, which represent approximately 90 per cent by market capitalisation and 15 per cent by number of ASX listed entities, have the resources and a sufficient number of non-executive directors on their boards to serve on a remuneration committee to ensure that the relative compliance costs are proportionate to the risks being addressed.

Executive director membership of remuneration committees creates the perception that remuneration committees are conflicted in advising the board on the remuneration arrangements for executive directors. The perception that remuneration committees are not adequately independent from executive directors in providing recommendations to the board on their remuneration arrangements has the potential to negatively affect investors’ and the community’s confidence in the corporate governance arrangements of listed entities in this area — hence the introduction of the Listing Rule.

Executive directors may attend remuneration committee meetings by invitation, to discuss the development and implementation of organisational remuneration policy, succession planning for the senior levels of management and the remuneration arrangements for the executive team, but the Listing Rule amendment clarifies that they have no role in deciding their own remuneration. By drawing a clear distinction between membership of, and attendance at, meetings of a remuneration committee by executive directors, the Listing Rule is designed to reinforce the importance of remuneration committee members bringing independent judgment to bear on their advice to the whole board.

ASX did not consider it appropriate to extend the requirement for a remuneration committee that is comprised solely of non-executive directors beyond the top 300 ASX listed entities because of the significant number of companies outside the top 300 that would not have enough non-executive directors on their boards to serve on a remuneration committee. In these circumstances, such a Listing Rule requirement would operate to impose a de facto requirement with respect to the composition of boards of smaller companies, which would represent a significant and disproportionate compliance cost for these entities.

For these entities, the model set out in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* provides good guidance on the composition of remuneration committees, as it is a model that is appropriate for smaller companies where a separate remuneration committee may not exist, due to board size. The guidelines state that:[5]

> The remuneration committee should be structured so that it:
> - consists of a majority of independent directors
> - is chaired by an independent director
> - has at least three members.

This composition ensures that there is an independent review of remuneration structures and any professional advice received on remuneration.

Under Australian corporations legislation, non-executive director remuneration is subject to shareholder approval and the Listing Rules require that total remuneration of non-executive directors cannot be increased without shareholder approval.

6. Would there be any benefits of requiring companies to include employee representatives on remuneration committees and what would be the risks and practical implications of any such measures?

As noted above, executive directors may attend remuneration committee meetings by invitation, to discuss the development and implementation of organisational remuneration policy. The CEO will automatically represent employees in any discussion on the organisational remuneration policy.

Commentary on executive remuneration tends to compare the highest remuneration extended to senior executives, particularly the CEO, with the lowest remuneration extended to employees in very junior positions. Such comparisons excite considerable disquiet at the disparities in the levels of remuneration.

However, CSA notes that there are differing levels of remuneration extended to a range of employees between these two bands. When the levels of remuneration in a large public listed company are reviewed at each band of employment, the disparity between each band is usually not extreme. Virtually all of this information is not publicly available and generally not well understood.

There is a relationship between director and executive remuneration and that of other employees. In most large companies, performance plans are in place providing incentives to employees at all levels to achieve agreed targets. Key performance indicators (KPIs) will differ from company to company, but both short-term and long-term incentives (STIs and LTIs) as motivations for achievement are common. Frequently, directors will determine that those executives whose decisions have an impact on financial results will be on the same or a similar performance plan as the CEO. While the next most senior executives may not be on the same plan, directors typically have regard to relativities, in order to motivate employees and for reasons of internal equity.

Directors usually determine the specific remuneration of the CEO and the top executives reporting to the CEO and focus more broadly on the remuneration of other employees. The incentive plans of large companies often apply to many other executives and it is common for the board to approve participation in these plans. In considering this participation, directors

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[5] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments*, 2nd Edition, 2010, p 37

usually have regard to remuneration of the participating employees at all levels, and the relativities between them.

In all companies there must be an appropriate link between the items on which employees (executives or otherwise) are being rewarded and the actions they are able to take to influence the desired outcomes. Clearly, senior executives have relatively large decision rights that enable them to have relatively greater influence over the company's desired outcomes. Directors also usually take into account any external information that may be available concerning employee remuneration at different levels, for example, competitor companies.

Employee representation on boards is counter to the system of governance operating in both Australia and the UK. Australia and the UK subscribe to the unitary board model and does not follow the two-tier board model operating in Europe. It is not that employees have no role to play in the development of organisational remuneration policy, but that the legal framework that applies in Australia does not provide for such representation on boards. The same questions arise in relation to employee representatives on boards as arise in relation to shareholder representatives on boards, in that they become board members whose fiduciary duty is to act in the best interests of the company as a whole rather than representing more narrowly defined interests.

Notwithstanding this, there are a number of independent watchdogs operating in Australia who are keen to review board decisions in relation to executive remuneration and whose reviews represent the interests of employees in a variety of ways. These watchdogs include the media, proxy advisory firms and the Australian Council of Superannuation Investors (ACSI), which represents institutional investors, primarily industry superannuation funds. The superannuation funds, of course, ultimately represent superannuants who are largely employees.

7. What would be the costs and benefits of an employee vote on remuneration proposals?

CSA notes that the 'two-strikes' rule for the non-binding vote on the remuneration report provides that, if 25 per cent of the votes cast at two consecutive AGMs oppose the adoption of the remuneration report, then at the second AGM the company must give shareholders the option (if 50 per cent or more of votes cast are in favour of a 'spill') to require that the entire board (except the managing director) stand for re-election at a further general meeting. This meeting must take place within ninety days.

Employees are already shareholders in many companies, and thus they already have a vote on the remuneration framework and board decision making in this regard.

8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

In 2011, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011*, which took effect on 1 July 2011, introduced disclosure requirements of remuneration consultants as follows:

- The board or remuneration committee must approve any contract to engage a remuneration consultant.
- Remuneration consultants may only provide remuneration recommendations regarding KMP to the directors (except the executive directors), or the remuneration committee, or both. The remuneration recommendation must be accompanied by a declaration that it was free from undue influence of KMP.
- The remuneration report must contain certain details relating to remuneration consultants. Information about arrangements put in place by the board to ensure that

> the remuneration recommendation was free from undue influence from the relevant members of KMP and a statement about whether the board is satisfied that the remuneration recommendation was free from undue influence and the reasons for this must also be included. The amounts paid to the remuneration consultant for executive remuneration advice and, separately, the amounts paid for other kind of advice must also be disclosed.

Any person external to the company who makes a remuneration recommendation under a contract for services with the company will be a ‘remuneration consultant’ (there are limited exceptions for legal, accounting or actuarial advice).

During the consultation phase, strong concern was exhibited that the original drafting of the amended law prohibited management from seeking remuneration advice. CSA, and others, noted that in large companies, remuneration is much broader than remuneration for the executive group alone. It is appropriate at times for management to also engage remuneration advisers, not to determine their own remuneration, but to determine the remuneration of staff across the company. Most companies do not have significant in-house remuneration resources, and require access to external advisers.

It is important that any regulation requiring increased transparency of the use of remuneration consultants does not make boards responsible for the remuneration of all operational staff within a company. For example, a large company could employ 30,000 staff, and it would be an inappropriate use of board time and expertise to have the directors setting the remuneration for all staff in such situations. Moreover, it is appropriate for any remuneration advisers commissioned by the board to meet with management so that their advice to the board is informed by having access to information about the business, its prospects, its market positioning etc. It will be difficult for the board to make decisions on remuneration packages for senior executives if discussions with management are prohibited.

Structure of remuneration

9. Could the link between pay and performance be strengthened by companies choosing more appropriate measures of performance?

The link between pay and performance is at the very heart of aligning remuneration with shareholders’ interests. CSA Members strongly believe that any strengthening of this link is best achieved through disclosure and a non-binding vote on the remuneration report. The non-binding vote corrects any inappropriate link, as shareholders provide feedback to directors as to whether their remuneration decisions are acceptable or not. From an investor’s perspective, the ‘say on pay’ is one of the most significant ways to ensure that the board is managing the CEO and their team for the benefit of shareholders.

Importantly, the non-binding vote on the remuneration report, while providing the opportunity for shareholder scrutiny of board decision making on remuneration and the opportunity to express shareholder views and engage with boards, is not a ‘one-size-fits-all’ approach. It provides the flexibility for review and comment by shareholders, while providing boards with the capacity to set remuneration structures and frameworks that they view as being in the best interests of the company.

Investors now have many different financial and other interests in companies and are not necessarily long-term investors (they can be 24-hour investors). Shareholders today are a diverse group, dispersed geographically (including internationally) and, in many large companies, can number in the thousands, if not the millions. With dynamic and global investment strategies, shareholders may include an individual resident in Australia planning for his or her retirement, a large institution with billions of dollars under management, a foreign investor, a global hedge fund, and an investor with no interest in the company beyond a short-term trade. The traditional retail investor in Australian equities may represent a small proportion of the capital of a large ASX-listed company.

Given the diversity of investors and their different interests, it is clear that those interests are not always aligned. Investors will, therefore, have different views on the performance hurdles that should be applied to executives. Even long-term shareholders can have different views on appropriate measures of performance.

In Australia, since the introduction of the non-binding vote on the remuneration report in 2005, practice has become relatively consistent, in that most companies choose a split of external, objective and measurable performance hurdles and internal hurdles that are important to the particular business. Proxy advisory firms actively monitor companies that seek to impose performance hurdles that reward behaviour that is not 'stretched'.

Companies have the flexibility to put in place performance measures that are important to the strategic intent of the business, while external monitoring ensures that those hurdles are not too easy to meet. In addition there is the requirement to disclose the performance measures in the remuneration report, which is where the board has the opportunity to explain the 'why' of remuneration, not just the 'what'. However, it is not possible to always choose performance hurdles that satisfy each and every shareholder — there is no 'one' approach that will find total acceptance.

CSA believes that it is for shareholders to test directors' thinking and behaviour through shareholder engagement and for boards to be accountable to justify their decisions to shareholders. Each company is unique and its circumstances may change dramatically and suddenly. Companies need the freedom to organise themselves and respond most effectively to the needs of the day. Remuneration needs vary considerably between companies and over time within a particular company. A regulated approach setting out only one model for setting remuneration will deprive companies of the ability to respond most effectively to the needs of the day, and almost certainly will drive inefficiencies and unwanted outcomes.

CSA is of the view that the combination of disclosure and a non-binding vote on the remuneration report focuses both the board and shareholders on the performance hurdles as well as whether they are appropriate and that this approach strengthens the link between pay and performance.

10. Should companies be encouraged to defer a larger proportion of pay over more than three years?

CSA Members are of the view that deferring a larger proportion of pay over more than three years can avoid the need for retention payments to executives. However, we note that, for many executives, deferral of reward over five years or more means that such payments are no longer considered an incentive. Accordingly, we believe that deferral of short-term incentives for one to two years is appropriate. Long-term incentives are deferred by their very nature, as they do not vest until certain performance conditions are met at a future time, usually three to five years in Australia.

11. Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed?

In Australia there has been a move away from three-year grants to an annual review of performance hurdles. The feedback from the non-binding vote on the remuneration report is taken into account when performance hurdles are set — engagement between boards and shareholders throughout the year also contributes to board decision making in the setting of performance measures.

However, it is of concern to review the use to which the ‘two-strikes’ rule has been put by shareholders in some smaller companies in Australia. For example, a new shareholder seeking to become a majority shareholder in Tassal Ltd voted against the remuneration report in order to destabilise the board. A major shareholder of Cedarwoods Ltd voted against the remuneration report because the board had rejected a takeover offer that the shareholder wanted the board to accept. CSA Members are concerned that neither of these actions represented a vote against remuneration decisions.

12. Would radically simpler models of remuneration which rely on a director’s level of share ownership to incentivise them to boost share value more effectively align directors with the interests of shareholders?

Director and executive share ownership was introduced in Australia in response to shareholder activism, which sought to ensure that the interests of directors, executives and shareholders were aligned. The Financial Services Council’s (formerly the Investment and Financial Services Association) guidelines for fund managers and listed companies on corporate governance specifically states that ‘The board should establish and disclose in the annual report a policy to encourage non-executive directors to invest their own capital in the company or to acquire shares from an allocation of a portion of their fees.’[6]

In the last two decades, the introduction of variable pay, both in cash and in shares and rights to acquire shares, became the favoured model to help align the interests of executives with the interests of shareholders of listed companies.

It should be noted that in Australia, under the corporations law, non-executive director remuneration is subject to shareholder approval. ASX Listing Rules require that total remuneration of non-executive directors cannot be increased without shareholder approval.

The Listing Rules also require shareholder approval for a new issue of shares granted to directors (encompassing executive and non-executive directors). A new issue will dilute the value of existing shareholders’ securities by increasing the number of securities on issue while total equity remains unchanged.

In Australia, non-executive directors’ remuneration is not subject to performance hurdles and nor do they receive retirement benefits or options or bonus payments. The first edition of the ASX Corporate Governance Council’s *Corporate Governance Principles and Recommendations* in 2003 provided guidelines on non-executive director remuneration, which ensured that non-executive directors did not participate in schemes designed for the remuneration of executives.

Therefore, in Australia, executive and non-executive remuneration are properly contained. It provides clarity to the market generally to differentiate between non-executive and executive directors’ remuneration.

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[6] Investment and Financial Services Association, *IFSA Guidance Note No. 2.00 Corporate Governance: A Guide for Fund Managers and Corporations,* 6th edition, June 2009, Guideline 11 — Equity Participation by Non-Executive Directors, p 8, published by the Financial Services Council. This Guide is commonly known as the IFSA Blue Book

13. Are there other ways in which remuneration — including bonuses, LTIPs, share options and pensions — could be simplified?

CSA is of the view that the separation of executive remuneration from non-executive director remuneration, as exists in Australia, is helpful in simplifying remuneration (see our response to Q12).

CSA also notes that a consultation on simplifying narrative reporting is running in the UK concurrently with the consultation on executive remuneration. This consultation specifically seeks feedback (Q17—19) on how disclosure of remuneration should be undertaken.

CSA recommends that it is useful to have a disclosure requirement in the remuneration report of the five highest paid employees. However, CSA Members caution that the definition needs to be considered carefully, as identifying the five most highly remunerated employees may be made difficult in the context of people changing roles or leaving or commencing employment part-way through the year and because categorisation depends on actual responsibilities and influence rather than role descriptions and reporting lines. For example, a termination payment to an employee of many decades' service, with attendant accrued legal entitlements (annual leave, long service leave etc), could see the employee meet the requirements of the definition of one of the five most highly remunerated employees for the purposes of the remuneration report.

14. Should all UK quoted companies be required to put in place clawback mechanisms?

CSA agrees that mechanisms to facilitate the recovery of amounts paid to executives based on financial statements subsequently found to be materially misleading are in the best interests of shareholders. It is appropriate commercial practice for a company to negotiate such an outcome and reflects good corporate governance. CSA is of the view that legislative prescription is not required to facilitate such recovery and may be undesirable and counter-productive.

The Australian Government consulted on this issue earlier this year. At the time of writing this submission, the government has noted it is still considering the issue but is conscious that many submissions on its consultation paper highlighted concerns with the workability of a legislative approach to clawing back remuneration.[7]

CSA is of the view that the clawback of executive remuneration is best dealt with in the employment contract between an executive and the company, with directors accountable for their decision through disclosure to their shareholders as to whether such contractual arrangements are in place. While legislation appears to be a holistic solution, with a clear enforcement capacity, it is an inflexible approach that provides a one-size-fits-all solution that is not appropriate to apply to all companies.

Legislation would mean that the provision would need to be narrowly confined to the CEO and the CFO as those who are required under Australian corporations law to provide certifications to the board on the accuracy of the financial statements, whereas a company might decide that it wants a clawback provision to apply more widely to other executives.

Legislation would need to be confined to intent, whereas a company might decide that its clawback provisions apply to any unjust enrichment even if the individual is not at fault. Intent is very difficult to prove.

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[7] The Hon David Bradbury MP, Parliamentary Secretary to the Treasurer, Redefining *Executive Remuneration and Performance*, Keynote Address to IQPC, Remuneration and Reward Conference, Melbourne, 19 October 2011

Remuneration is structured differently in individual companies. In addition, the greater liberty in designing and implementing provisions to recover erroneously awarded remuneration could expand to include unjust enrichment where there was no intent to fraudulently misstate financial statements, should that be appropriate to the company. That is, boards would need to decide when formulating their policy on clawback provisions if they intend it to apply to executives beyond the CEO and CFO, who sign off financial statements, or if it is intended to apply regardless of fault.

These questions are very important ones that boards need to consider and that cannot easily be dealt with by the prescriptive approach of legislation. For example, legislation does not and cannot cover the budgets on which short-term incentives are based — the payment of bonuses based on such key performance indicators are matters for the company policy on remuneration and the employment contract, which provides for a holistic approach. That is, the board is best placed to decide if the policy is not intended to penalise any employee unfairly, or if it is intended that the company not pay more remuneration than it should regardless of fault.

Under contract law, the company would have the capacity to take legal action against any employee under their employment contract. The choice as to how to recover the unjust enrichment is a matter for the company. This flexibility is in shareholders' favour.

CSA also notes that in Australia all entities regulated by the Australian Prudential Regulatory Authority (APRA) are required to

- design the performance-based components of remuneration to align remuneration with prudent risk taking, and
- be able to adjust any performance-based components to zero.

Although APRA's prudential standards do not specifically relate to the clawback of remuneration that has already been paid out or the clawback of remuneration due to the occurrence of financial misstatements, the standards require that any unvested performance-based component of remuneration be at risk, and must be able to be reduced or eliminated if long-term performance objectives are not realised.

Promoting good practice

15. What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

Proxy advisory firms collate this publicly available information and provide assessment of those practices to their institutional clients. The assessment includes recommendations on how to vote on items of business proposed to be decided at general meetings, including the remuneration report.

Accessing quality, independent information in relation to a range of issues assists institutional investors to discharge their voting responsibilities. Such information, which includes recommendations on voting on proposals to be put to shareholders, may have a material effect on voting results.

Remuneration consultants monitor remuneration levels and make recommendations to boards. The media also takes an active interest in remuneration frameworks, structures and levels.

CSA is of the view that there is no need for one agency to take on the role of coordinating research on executive remuneration, given that there are already private sector businesses highlighting emerging practice and providing accurate information on these issues.