



**CHARTERED SECRETARIES
AUSTRALIA**

Leaders in governance

17 July 2009

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Senators

Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

Chartered Secretaries Australia (CSA) is the independent leader in governance, risk and compliance. 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 comprise company secretaries and those with governance responsibilities in listed, unlisted, private and government-owned corporations.

CSA members agree with the introduction of a limit in relation to termination payments offered as 'golden handshakes'. When termination payments are granted during or following a period of poor company performance, shareholders can experience considerable disquiet at what is perceived as 'reward for failure'. However, although not attracting publicity, the majority of termination payments are not made in a context of poor company performance, and, therefore, CSA believes the legislation will need to carefully balance the legitimate interests of shareholders and executives. Good governance requires a practical and workable outcome.

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 and its remuneration committee. Our members are, therefore, uniquely positioned to provide independent, expert commentary on the governance and implementation issues arising from the proposed law reform of termination payments, including reporting to shareholders on this issue. Our comments in this submission are intended to ensure that the legislation can be practically implemented to achieve the policy outcomes sought.

Key recommendations

Our key recommendations are:

- The legislation should define the persons to whom it applies as the key management personnel and the five most highly remunerated executives in the previous accounting year (that is, those persons disclosed in the remuneration report) and *not* extend to

CHARTERED SECRETARIES AUSTRALIA LIMITED ABN 49 008 615 950

LEVEL 10, 5 HUNTER STREET, SYDNEY NSW 2000, GPO BOX 1594, SYDNEY NSW 2001 TEL +61 2 9223 5744 FAX +61 2 9232 7174 EMAIL info@CSAust.com

www.CSAust.com

persons who are directors of non-listed companies and subsidiaries or persons who have at any time in the previous three years held a 'managerial or executive office' in a company or a related body corporate (unless they are disclosed as key management personnel or the five most highly remunerated executives).

- A practical and workable manner to obtain shareholder approval for termination payments to departing executives is to permit a company to submit a termination policy to shareholders for approval, and only require specific shareholder approval for payments outside the approved policy.
- The Bill cannot be decided without review of the Regulations, which are not yet available for consultation. Our final three recommendations speak to the need to review the Regulations concurrently with the Bill.
- The definition of 'termination benefit' in the Regulations should exclude those ordinary course payments that apply to the length of service generally. 'Termination benefits' should only include any amounts that differ from what would be due to a person if they resign or retire in the ordinary course. When calculating one year's fixed salary, fixed salary sacrificed into superannuation (including accumulation funds), shares or a pension fund in another jurisdiction should be included within the definition of 'base salary' for the purposes of calculating the maximum permissible termination payment, and superannuation account balances should be expressly excluded from the calculation of a termination benefit, subject to any necessary anti-avoidance provisions to protect against abuse.
- Subject to a company's redundancy policy being of wide-ranging application across the company and disclosed, in the case of genuine redundancy, the key management personnel and the five most highly remunerated executives should be entitled to the same benefits that are available to employees generally under the terms of that policy and the payment should not require approval as a 'termination benefit', although it should be taken into account in considering whether any additional termination payments over and above those under the policy require approval.

Termination payments may be consistent with good governance

It is important to recognise that termination payments can and do serve a company's interests in many cases. Academic research has indicated that termination payments can be justified¹:

When considering the rationale behind the provision of termination payments to senior executives, the question that should be asked is: Why should an executive be rewarded at the moment his or her contribution to the company ceases to exist? The literature reveals four main arguments in support of such payments. First, termination payments can reward departing executives for long-term and/or outstanding service to the company.² Second, termination payments provide an incentive not to disclose corporate information to competitors or cause adverse publicity when leaving the company (whether through litigation or otherwise).³ Third, termination payments can help a company attract talented executives, as well as serve as a safety net, encouraging executives to take more risks in the interests of shareholders. This is particularly the case where an executive is hired to turn around a failing company. Usually the best people for the job have a secure position elsewhere, and thus the promise of a payment on departure can help convince an executive that he or she will

¹ Geof Stapledon, 'Termination Benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27: 683, 2005. At the time of publication, Geof Stapledon was Managing Director, ISS Australia, a key governance and proxy advisory firm in Australia, and Professor of Law, University of Melbourne

² John Shields, Michael O'Donnell & John O'Brien, *The Buck Stops Here: Private Sector Remuneration in Australia A Report Prepared for the Labour Council of New South Wales* (2003) at 7; Philip Cochran & Steven Wartick, 'Golden Parachutes: A Closer Look' (1984) 26 *California Management Review* 111 at 120

³ Dan Dalton, Catherine Daily & Idalene Kesner, 'Executive Severance Agreements: Benefit or Burglary' (1993) 7 *The Academy of Management Executive* 69; Cochran & Wartick, above

be adequately compensated for taking the risk, even if that risk ultimately does not pay off.⁴ Fourth, if there is a possibility of a company merging or being taken over, termination payments ensure a measure of objectivity on the part of executives during negotiations. Executives may otherwise not act in the best interests of shareholders because they are more concerned about losing their jobs following the change in management that will occur if their company is taken over by another.⁵

CSA believes that these reasons need to be borne in mind when reviewing the legislation, as it cannot be assumed that all termination payments are 'rewards for failure'. CSA believes that the legislation should carefully target 'rewards for failure' and on closing loopholes that provide opportunities for abuse, and avoid unnecessarily restricting genuine payments for retirement, resignation and death.

Our comments below are based on the key principles which we believe the proposed law reform is seeking to achieve:

- accommodation of the wide variety of circumstances leading to a termination payment
- the minimisation of loopholes
- boards being held accountable to an appropriate outcome
- shareholder and community expectations being met.

Wide variety of circumstances leading to a termination payment

There is a wide variety of circumstances that may lead to a termination payment. CSA is concerned that the Bill may inadvertently extend to commonly accepted bona fide payments made for:

- retirement (for example, accrued superannuation entitlements)
- resignation (for example, accrued annual leave entitlements)
- redundancy (for example, redundancy payments as per a company policy)
- death (for example, a death benefit payable by the superannuation fund to the person's estate).

CSA accepts that some of these issues may be dealt with in the Corporations Regulations, which the government has announced will deal with the definition of 'termination benefit' and which are yet to be released, but notes that the Bill cannot be decided without a concurrent review of the Regulations, which will detail which payments it is intended to apply. CSA has further comment on this later in our submission.

Extension of application of legislation beyond those disclosed in the remuneration report

Extending the present laws so that they apply to persons holding a 'managerial or executive office' with a company means that the legislation will apply to:

- for listed companies, those persons whose details were included in the directors' report (that is, the key management personnel and the five most highly remunerated officers)
- for companies that are not listed (including subsidiaries of listed companies), persons who are directors of the company or who hold any other office connected with the management of the company and are also a director of the company or a related company.

The legislation also extends the provisions to where the retiree has at any time in the previous three years held a 'managerial or executive office' in a company or a related body corporate.

⁴ Dalton, Daily & Kesner, above at 79

⁵ Peter Scotese, 'Fold Up Those Golden Parachutes' (1985) 63 *Harvard Business Review* 168 at 170; David Maurer, 'Golden Parachutes: Executive Compensation or Executive Overreaching' (1984) 9 *J Corp L* 346 at 351

Problems with expanded application

Large listed companies can have hundreds of non-listed subsidiaries in Australia. For example, BHP Billiton has over 200 (most of which are in Australia); ANZ has almost 100; Commonwealth Bank has in excess of 500 (most of which are in Australia), and Rio Tinto has approximately 300 subsidiaries. These listed companies will be subject to the legislation in respect of their subsidiary directors and executives.

The directors of the wholly-owned subsidiaries are often employees of the parent company, for example, general managers. These persons are often not senior at the scale of the parent company and their potential termination payments are not at a level that would concern shareholders in the parent company or the community. CSA believes that shareholders are most concerned with termination payments to the CEO and very senior executives of the parent company.

However, if the definition of ‘termination benefit’ in the Regulations is extended to catch all types of payments, including accrued annual and long service leave and salary sacrificed into superannuation, as was proposed in the exposure draft of the Bill, the calculation of termination payments to executives in subsidiaries could result in a payment larger than one year’s fixed salary, as it would capture general managers retiring and resigning, or subject to retrenchment. CSA cannot point to any public benefit or benefit to shareholders in imposing a new and onerous regulatory burden on companies that would require shareholder approval of termination payments of general management in the parent and subsidiary companies. As the persons caught by the extended definition are not those whose remuneration has caused any community or shareholder disquiet, CSA believes that it is an unintended consequence of the draft legislation that shareholder approval of their termination payments is now contemplated.

CSA does not believe that shareholders should approve the termination payments of the directors and executives of wholly-owned subsidiaries unless they are listed as key management personnel or the five most highly remunerated executives in the remuneration report.

CSA notes that, if the definition of ‘termination benefit’ in the Regulations specifically excludes all payments related to length of service, extending the application of the legislation becomes less of an issue.

CSA recommendation that shareholders be given the opportunity to approve a policy on termination payments

CSA understands that the proposed legislative reform aims to capture exit payments that do not reflect performance and those that enrich executives at the expense of shareholders and others. CSA agrees that shareholders should be able to approve or reject a termination payment to departing CEOs and senior executives above the proposed one-year limit.

The legislation provides that the shareholder vote may be obtained at any time prior to the payment being made to the director or executive. CSA believes that there is a workable approach to obtaining the shareholder vote.

CSA recommends that a practical approach to ensuring that the proposed law reform achieves the policy objective is to:

- permit companies to submit to shareholders for approval, every three years, a termination policy for key management personnel, to the extent that it may contain benefits outside the legislation — at the end of the three-year period shareholder approval will need to be renewed
- clarify that the termination policy as approved by shareholders will not include payout figures, given that the figures will be unknown until the time of termination or

resignation, or contracts have yet to be entered into following new appointments — that is, shareholders will be approving a formula or formulae

- require any termination payment outside the approved policy and formula to obtain shareholder approval as currently drafted.

CSA expects that, when seeking shareholder approval of a termination policy, companies would provide in the relevant notice of meeting examples of the quantum amount in relation to that formula for each key management personnel and five most highly remunerated executives based on existing rates of pay in the annual remuneration report.

Payments within the approved formula would be permissible and would not require the specific approval of shareholders. Shareholder approval would be required for any payments outside the approved policy.

This is a principles-based approach, which is in line with Australia's governance framework generally. It is based on exception reporting and would require boards to explain to shareholders why they are seeking to provide any termination payment outside the approved termination policy.

CSA's recommendation is based on our members' belief that:

- a principles-based approach is more likely to achieve the policy objective and is consistent with Australia's governance framework
- shareholders are provided with a level of control in the remuneration process and the payment of any termination benefits
- the costs of obtaining shareholder approval for specific termination payments (at shareholder cost) are minimised.

Definition of 'termination benefit' in the Regulations

We understand that the government intends to include details on what is captured in the definition of 'termination benefit' in the Corporations Regulations, rather than include it in the Bill, and that it intends to consult further with interested parties on this issue. However, as the Regulations have not yet been released, it is difficult to review how the Bill will operate in practice.

CSA believes that the Senate Economics Committee should review the Regulations and any definition of 'termination benefit' they may include concurrently with a review of the Bill, as the Regulations have implications for the effective operation of the Bill or otherwise.

We set out our concerns with the Exposure Draft definition of termination benefit below, to assist the Committee to understand why it is important that the Regulations be reviewed concurrently with the Bill.

Termination benefits should exclude ordinary course entitlements
The Exposure Draft of the Bill broadened the definition of 'termination benefit' to catch all types of payment made at termination and in all circumstances. CSA strongly believes that it is not appropriate to include in the calculation of 'termination benefit' those ordinary course entitlements that accrue according to length of service and that would apply broadly to employees within a company. For example, if a senior executive is made redundant after working for a company for 20 years and has accrued annual and long service leave, that executive is entitled to a redundancy payment together with the payout of that accrued leave and the company should not be required to seek shareholder approval for a payment which other employees receive as a matter of course.

CSA strongly recommends that any definition of 'termination benefit' in the Regulations should exclude those matters that apply to the length of service generally, such as:

- accrued annual leave
- accrued long service leave
- sick leave (to the extent that it can be cashed out)
- bona fide redundancy payments made in accordance with a policy applicable to all employees of the company
- short-term incentive (STI) or long-term incentive (LTI) payments (on a pro-rata basis) that have been earned during the period of employment but that become payable early as a result of termination of employment (a deferred bonus was already excluded in the draft regulations accompanying the draft bill)
- superannuation (including accumulation funds) or pension account balances already accrued
- the statutory superannuation contribution (which was already excluded in the draft regulations accompanying the draft bill).

These are accrued entitlements of the individual and should not be bundled together with 'rewards for failure'.

CSA recommends that the definition of 'termination benefit' in the Regulations should:

- exclude those matters that apply to the length of service generally
- only include any amounts that differ from what would be due to a person if they resign or retire in the ordinary course. This would capture payments in lieu of notice and most ex-gratia payments.

Superannuation

CSA notes that the statutory superannuation contribution was already excluded from the definition of a 'termination benefit' in the draft legislation. CSA believes that *all* superannuation should be excluded from the definition of 'termination benefit' in the Regulations, subject to any necessary anti-avoidance provisions to protect against abuse. Our reasons for this are that:

- it should be a matter for an individual to decide how they choose to take their salary; that is, they should have the right to choose to take it as cash, shares or salary sacrifice into superannuation where facilitated by the company
- voluntary contributions may have been made over many years
- such contributions were paid as salary in the period prior to termination
- superannuation contributions sacrificed from salary are the property of the employee.

For example, an individual earning \$200,000 per annum may sacrifice \$50,000 into superannuation each year. They work for the company for five years. When terminated, their salary should be calculated as \$200,000, as this was the fixed salary attached to the position. The \$50,000 sacrificed per annum into superannuation should not be counted for the purposes of calculating the termination benefit, but should be counted for the purposes of calculating salary, as should the statutory superannuation contribution attached to that salary. Despite how the Australian Tax Office treats such monies, such amounts are available as salary and should be treated as part of 'base salary' for the purposes of calculating the maximum permissible termination payment.

The \$250,000 that the individual has accrued in superannuation via salary sacrifice should be expressly excluded from the definition of termination benefit in the Regulations. It operates in such circumstances as a bank account — that money is the property of the individual.

CSA also notes that there are key management personnel who are employed by Australian companies but who work overseas and whose conditions relate to the jurisdiction in which they work. BHP Billiton and Rio Tinto are two examples of such companies. For example, the chief executive of Rio Tinto is based in London and has pension entitlements that are disclosed in the remuneration report. The draft legislation did not recognise monies accumulated in such pension funds as salary, on the basis that such a fund is not 'superannuation under the laws of

the Commonwealth'. CSA believes that the equivalent of superannuation funds offshore should receive the same treatment as superannuation.

The draft legislation excluded any defined benefit plan that was in place prior to the proposed legislation being enacted from the definition of termination benefit. The amount paid on exit is attributable to a formula that was, frequently, set in place many years ago. CSA supported this, as it is consistent with CSA's concern that it would be unfair to discriminate against long-serving employees.

CSA recommends that, when calculating one year's fixed salary, fixed salary sacrificed into superannuation (including an accumulation fund), shares, or a pension fund in another jurisdiction should be included within the definition of 'base salary' for the purposes of calculating the maximum permissible termination payment, and superannuation account balances should be expressly excluded from the calculation of a termination benefit, subject to any necessary anti-avoidance provisions to protect against abuse (that is, to protect against hiding a large termination payment in superannuation).

The difficulties of requiring shareholder approval of bona fide redundancy payments

Positions in companies are made redundant for a variety of reasons. Redundancy occurs at all levels and is often subject to a company's redundancy policy. A senior executive position could be made redundant because an industry is consolidating through mergers and acquisitions, because a company is restructuring, or because of difficult economic circumstances facing an individual company. Genuine redundancy is not about poor performance. It relates to the restructuring of the company in response to an adverse change in the circumstances of that entity.

CSA believes that in circumstances of genuine redundancy it is widely considered to be appropriate to make a termination payment. Such a payment would often be minimal in circumstances of a short-term appointment. However, a long-serving employee, possibly promoted during that tenure for good performance, may be entitled to a significant payment.

Where company policies apply to employees generally, it would be inappropriate to discriminate against long-serving senior executives who are made redundant. For example, a person with 25 years' service may have a six-month notice period plus a payment based on a broad company policy reflecting long service with the company (say, two weeks per year totalling 50 weeks). Under the terms of the draft legislation, a long-serving executive may not be able to be paid a redundancy payment without shareholder approval. Until the Regulations appear, with clarity as to the definition of 'termination benefit' it is impossible to know if long-serving employees made redundant will require shareholder approval of their redundancy payment.

Genuine redundancy payments are not unreasonable payments, and should include those long-term and short-term incentive payments (on a pro-rata basis) already earned if they amount to more than one year's base salary without being contingent on approval by shareholders.

CSA recommends that, subject to a company's redundancy policy being:

- of wide-ranging application across the company (that is, it extends beyond the key management personnel), and
- disclosed,

in the case of genuine redundancy, the key management personnel and the five most highly remunerated executives should be entitled to the same benefits that are available to employees generally under the terms of that policy and the payment should not require approval as a 'termination benefit', although it should be taken into account in considering whether any additional termination payments over and above those under the policy require approval.

CSA notes that Taxation Ruling TR 2009/2 provides guidance as to when a payment made to a person whose employment is terminated qualifies for treatment as a genuine redundancy payment under section 83-175 of the *Income Tax Assessment Act 1997* (Cth).

Other areas of concern with legislation

The legislation relates to contracts entered into, renewed, extended or varied after commencement of the Act. This will capture an even wider group than the exposure draft which affected contracts 'entered into or extended' after commencement, as now that the Bill applies to contracts 'varied' in relation to remuneration (that is, pay rises), it includes virtually all contracts. This is a substantial shift in the policy position that has not been subject to public consultation and is, in effect, a retrospective application.

Our concern is that this amendment does not provide employers the opportunity to structure a contract to ensure that a termination payment would fall within the thresholds in the Act. This undermines the policy objective, as it fails to allow companies the opportunity to be proactive in ensuring that community and shareholder expectations are met.

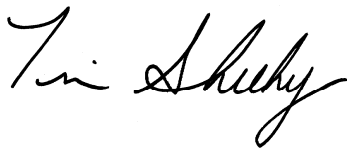
There is also a difficulty attached to averaging the base annual salary over three years (if the relevant period is three years or more) as a reasonable estimate of the amount the executive would have earned from the company and related bodies corporate during the relevant period. This does not take into account a change in position that may occur for a particular executive, for example, an executive could be promoted to CEO. The legislation needs to base the annual salary on the executive's position or equivalent position held, not on an earlier more junior position.

Finally, the Explanatory Memorandum states that the 'Compliance cost impact' is nil. Given that the Bill would extend to a wide range of executives, CSA disputes the claim that compliance costs will be nil. Companies will need to employ remuneration and legal advisers to structure (and restructure) contracts, and will also need to educate a wide range of managers as to the potential for their retirement, retrenchment or resignation remuneration to be subject to shareholder approval. If the Regulations include in the definition of 'termination benefit' ordinary course entitlements and salary sacrificed into superannuation, the text of notices of meetings will need to be substantially expanded to educate shareholders as to why various termination payments are being presented to them for approval.

Conclusion

In preparing this proposal for a practical and workable implementation of policy, CSA has drawn in particular on the expertise of its two internal national policy committees, comprising company secretaries from a range of listed and unlisted public companies. We would welcome the opportunity to meet with members of the Senate Economics Committee to discuss any of our views in greater detail. Please call me if you would like to set up a meeting. I can also arrange a meeting with our members.

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE