CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

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Dear Mr Walker

Directors' pay: revised remuneration reporting regulations

Chartered Secretaries Australia (CSA) is the peak body for over 7,000 governance and risk professionals in Australia. It is the leading independent authority on best practice in board and organisational governance and risk management. Our accredited and internationally recognised education and training offerings are focused on giving governance and risk practitioners the skills they need to improve their organisations' performance. 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.

We welcome the opportunity to comment on the consultation paper, *Directors' pay: revised remuneration reporting regulations* (the paper). CSA is interested in this issue because any reform in the United Kingdom (UK) will affect UK/Australia dual-listed companies and we are also conscious of the increasing convergence of regulation globally. This submission is considered relevant as earlier consultation papers referenced the changes in law relating to executive remuneration that have been introduced in Australia.

CSA believes that shareholders should have the capacity to hold directors accountable for their decisions on remuneration, as well as other decisions affecting the performance of a company. We support in principle proposals that aim to ensure that robust governance arrangements are in place to ensure director accountability when setting executive remuneration. Notwithstanding this, we have taken the opportunity to point to the practical implications of some of the proposals.

Our comments on the consultation questions follow.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

General comments

CSA notes that there are practical implications that require attention in order for the regulations to be practically and feasibly implemented.

- The implications of a binding shareholder vote on remuneration policy remains problematic for companies in relation to executive directors who have not yet been appointed, particularly those from other jurisdictions. For example, a proposed CEO may be a Canadian, and seeking a contract with Canadian terms outside of the approved remuneration policy. This candidate is the best person for the role, as the board has conducted an international search and subjected all candidates to a due diligence process and informed consideration. It is not in shareholders' interests for the candidate to be rejected, due to the remuneration policy.
- If the legislation is too prescriptive, it will not be able to accommodate circumstances as they arise. There is no provision for directors to make retention payments to key staff at the times when they may be most needed, that is, when the company is experiencing difficulties or subject to a takeover and key people need to be retained.
- CSA recommends that some form of flexibility be granted to the board to act in the best interests of the company in relation to remuneration structures.
- Transition payments have not been accommodated in the draft regulations. Any reform to apply a binding vote to remuneration policy needs to take account of long-term contracts that have been in place for some time. Although legislation can override an employment contract, we strongly recommend that the principle at law of legislation not taking retrospective effect should operate. Any new law should apply to new contracts only.
- If the remuneration policy is rejected by shareholders, the existing remuneration policy will continue to apply. This policy may be one that has also caused shareholder disquiet. Shareholders would therefore remain upset with the board in relation to its remuneration decisions, with no means of breaking the deadlock. CSA notes that the annual election of directors under the 'comply or explain' provisions of the UK Combined Code applies only to the FTSE300.
- The principles on which the determination of exit payments will be made 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; pension/superannuation (contributions and payouts); deferred bonuses (that is, already earned with no further performance condition); insurance payments (for example, if the person leaves because they are disabled or have died); and other applicable entitlements applicable in the UK and globally. The global issue is important — the UK is not the only jurisdiction in which FTSE companies employ and pay executives. These are accrued entitlements of the individual and should not be bundled together with 'rewards for failure'. It should be absolutely clear in the regulations that the person can be paid these legal and other entitlements upon termination and without waiting for the shareholder vote on the remuneration policy.
- Companies will still need to report against the Accounting Standards. The proposed method of reporting remuneration will not match that required by the Accounting Standards, which could give rise to confusion and lack of comparability.

CSA is concerned with the impact of the proposed new regulations on dual-listed companies, as the proposed regulations conflict at times with existing legislation in this jurisdiction. Such conflict is likely to create difficulties for dual-listed entities in complying with the law in both jurisdictions. For example, we note that the proposed disclosure requirements on pensions cannot be applied absolutely to dual-listed entities, given that they will employ directors who do not have payments made into such pension schemes. For example, both BHP Billiton and Rio Tinto make payments for executive directors into Australian superannuation funds, which is a statutory obligation under Australian law. Any changes to UK regulation need to take account of the existing statutory obligations of other jurisdictions.

We also note that the paper refers to directors, which term captures both executive and non-executive directors. However, the regulations will only apply to executive directors in Australia.

1. Question 1: The Government seeks comments on how well the draft regulations attached at Annex B give effect to the policy set out in this consultation document.

CSA's comments on aspects of the draft regulations are set out in our responses to later questions.

Question 2: What costs will companies face in adjusting to these revised reporting regulations?

There will be additional costs of compliance in any company, but dual-listed entities will bear further additional costs. They already report in two (or three) jurisdictions and will now need to also align two different reporting frameworks. Such alignment and reporting will demand an allocation of resources above and beyond that contemplated in an entity listed only in the UK.

Question 3: The Government intends to introduce a table which sets out the key elements of remuneration and supporting information on the pay policy. The Government does not propose to prescribe the specific disclosures that are required for each element of pay. Is this a practical and informative approach?

CSA supports the introduction of a table setting out the key elements of remuneration and supporting information on the pay policy. Our comments on particular aspects of the disclosure requirements are set out in our responses to later questions.

Question 4: The Government intends to introduce reporting requirements on service contracts, what remuneration directors can receive in different scenarios and the percentage change in profit, dividends and overall expenditure on pay in the reporting period. Is this a practical and informative approach? If an alternative disclosure would be useful, please give details.

While requiring disclosure of the percentage change in profit, dividends and overall expenditure on pay sounds feasible in theory, in practice pay may not be tied to company performance in a particular year. For example, long-term incentives (LTIs) may be over a three-year period and the pay results therefore may not be directly related to performance results in the year of their award. In such circumstances it is therefore not possible to make a direct comparison of the spend on pay with company performance and disclosure under these terms could be misleading.

CSA supports boards having to scenario test the remuneration directors would receive according to different circumstances. However, CSA is of the view that disclosure of the best-case scenario could be read by the media and shareholders as a 'given', with scant attention paid to disclosure of the worst-case scenario. CSA recommends a disclosure requirement that provides shareholders with sufficient information on which to base their voting decision (that is, negative and positive impact statements) rather than disclosure of the absolute best-case and worst-case scenario, that is, a ‘target’ or ‘expected’ outcome rather than a best or worst-case scenario.

Question 5: The Government proposes that a company’s statement on its approach to exit payments sets out the principles on which the determination of the payment will be made. If additional information would be useful, please give details.

CSA members agree with the introduction of a disclosure requirement setting out how the company determines exit payments. When exit payments are made during or following a period of poor company performance, shareholders perceive this as ‘reward for failure’.

However, there is a wide variety of circumstances that may result in an exit payment. Commonly accepted bona fide payments can be made for:

- retirement (for example, accrued pension 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 company, insurer or pension fund to the person’s estate).

CSA strongly believes that payments of those ordinary-course entitlements that accrue according to length of service and that would apply broadly to employees within a company should be expressly excluded from any disclosure requirement as to how the company determines exit payments. In other words, they should be excluded from a requirement for shareholder approval.

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 reasonable redundancy payment together with the payout of that accrued leave.
CSA recommends strongly that the disclosure requirement for how the company determines exit payments specifically exclude certain legal and other entitlements including:

- pension/superannuation (contributions and payouts)
- accrued annual leave entitlements
- accrued sick leave entitlements
- long service leave entitlements
- ‘bona fide’ redundancy payments limited to redundancy payments which apply to the executive in the same way as they apply to the company’s employees generally
- deferred bonuses (that is, already earned with no further performance condition)
- insurance payouts (for example, if the person leaves because they are disabled or died), and
- other applicable entitlements applicable in the UK and globally. The global issue is important — the United Kingdom is not the only jurisdiction in which FTSE companies employ and pay executives.

CSA notes that this issue was dealt with in Australia appropriately and as we have recommended.

Question 6: The Government would welcome views on the proposal for the policy part of the remuneration report to include a statement on whether and if so how a company sought employee views on the remuneration policy.

The financial interest in a company rests primarily with the shareholders, although the interests of creditors, employees and the broader community are also important. CSA is of the view that boards would be wise to take into account the views of its employees on remuneration.

However, CSA does not support a requirement for companies to expressly set out in the remuneration report details of communications between the board, management and employees on remuneration policy. CSA is concerned that such an obligation could elevate the concerns of employees over those of shareholders. We note that shareholders' concerns are neither sought nor described under these proposals.

In addition, CSA has doubts that the resulting disclosures would be particularly meaningful and is concerned that they may be more likely to cause more internal difficulties than benefits. Bland statements that a company has consulted with employees will not be particularly enlightening for readers of the report. Lengthy disclosures of discussions held will add to the length of the report without necessarily adding any particular clarity. One can imagine that any such disclosures would immediately be met with internal debate along the lines of: 'Which employees in particular did the company consult? Would the outcomes have been different if other employees had been consulted? How many different groups of employees should a company consult and in which jurisdictions?'Which unions were consulted?

CSA notes that it is relatively common for large numbers of employees to already 'have a say' in their capacity as shareholders. Many listed companies have broad-based employee share plans, giving participating employees the right to express their views on the company's remuneration framework by voting on the remuneration report as shareholders.

Question 7: The Government's intention is that the single total figure includes remuneration that becomes receivable as a result of the achievement of conditions relating to performance in the reporting year where the reporting year is the last year of the performance cycle. Do the specific disclosures set out in the table on page 24 correctly give effect to this intention?

CSA supports a single total figure to aid shareholder consideration of the remuneration policy. CSA also supports the findings of the *Lab project report: A single figure for remuneration*, which the UK Government has referred to in preparing its proposals.

We note that it is important to ensure that double counting never occurs between years.

Question 8: The Government proposes the application of the HMRC methodology to work out the value of defined benefit pension schemes. Is this a practical and informative approach?

CSA is of the view that it is for UK stakeholders to comment on this proposal.

Notwithstanding this, CSA does note that companies may employ people who are not awarded benefits through such pension schemes. For example, the executive directors of dual-listed entities BHP Billiton and Rio Tinto are paid under the statutory superannuation scheme operating in Australia. CSA recommends that any regulation of disclosure requirements needs to accommodate differences such as this.

Question 9: The Government proposes that claw-back is recorded as part of the single figure. Is this a practical and informative approach?

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 therefore supports the proposal that clawback should be recorded as part of the single figure if it occurs, with an accompanying explanation as to its occurrence.

Question 10: The Government would welcome views on whether it would be commercially sensitive to require companies to publish full details of performance against metrics. If so, how can an appropriate degree of flexibility be achieved?

CSA has some concerns with this proposal. Although CSA supports disclosure of the performance hurdles selected by a company, upfront detailed disclosure of internal hurdles may cause commercial difficulties for companies. It is unreasonable to assume that external hurdles (such as total shareholder return) will be the best metrics for all companies. Companies should be free to choose the metrics that best suit their circumstances, which will change over time. In CSA's view, the emphasis on 'detailed disclosure' should occur at the end of the performance/testing cycle, when the long-term incentive has vested/lapsed. At the end of the long-term incentive cycle the commercial sensitivities should have passed, and shareholders are most interested in remuneration outcomes *vis a vis* company performance.

Question 11: Will the Government's proposed disclosure requirements on pensions lead to reporting of sufficient information on the benefits received by directors?

CSA is of the view that it is for UK stakeholders to comment on this proposal.

Question 12: The Government proposes that scheme interests awarded to directors during the reporting year are disclosed at face value. Is this a practical and informative approach?

CSA notes that, in Australia, the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* recommend that non-executive directors not participate in performance-based equity incentive schemes designed for the remuneration of executives. CSA is of the view that it is for UK stakeholders to comment on this proposal.

Question 13: The Government proposes to simplify the reporting requirements regarding directors' interests. What are the costs and benefits of this approach? If an alternative disclosure would be more useful, please give details.

CSA strongly supports the simplification of reporting requirements and hopes that the proposed new regulations will indeed lead to such simplification. However, CSA notes that it may be useful to set a threshold for such reporting, given that the directors' holdings in large companies are likely to be immaterial, with no capacity to influence voting control, compared to those in companies where directors could hold substantial shareholdings. Such a threshold could be five per cent.

Question 14: The Government proposes that the remuneration report includes a graph that plots total shareholder return, as a proxy for company performance, against CEO pay. Do you agree that this graph would be useful? If so, do you agree that total shareholder return and CEO pay are the best proxies for company performance and pay? If not, what measures would be more appropriate?

CSA notes that total shareholder return may not be the metric employed by all companies as a proxy for company performance. CSA does not support regulation prescribing the metrics that companies should use. For example, in the property industry, returning money to shareholders may not be in their best interests as they need to maintain capital in the buildings. The mining industry is a long-term business and total shareholder return would not always equate to executive performance.

CSA also notes that it is unlikely that total shareholder return will be used as a metric over one year. It is more likely that it would be used over a five-year period.

Question 15: The Government proposes that the single figure, detail of performance against metrics, total pension entitlements, exit payments made and detail on variable pay are all subject to audit. Are there any other sections of the report that should be subject to audit?

CSA supports an audit of the single figure, as this provides a level of assurance that should give comfort to shareholders.