Submission to Corporations and Markets Advisory Committee on

Executive remuneration - Information paper

13 August 2010

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1. General Comments

We understand that CAMAC's brief is to reduce the complexity of remuneration reporting and put forward proposals to simplify the incentive components of executive remuneration.

The Productivity Commission has proposed an architecture that we believe is simple, practical and effective, but there is a high level of complexity in the current reporting and incentive arrangements, arising from:

- Current regulatory environment
- Accounting standards
- Tax rules
- Wide ranging and often conflicting views about appropriate remuneration arrangements and reporting (as evidenced by the submissions made to the Productivity Commission inquiry[1]).

2. Effectiveness of Current Reporting and Disclosure Framework

2.1 Regulations

It is very important that new regulations are sufficiently clear and definitions are specific enough to ensure companies report the same remuneration items, so that useful comparisons can be made.

Simple disclosures will better enable shareholders to make informed decisions about the remuneration arrangements in an organisation.

2.2 Extent of disclosures

The current level of disclosures is unnecessarily onerous, and in some instances adds very little further information or insight for shareholders. For example, the disclosure of the 5 highest earners either duplicates (key management personnel) KMP disclosures or leads to inconsistent year on year disclosures, allowing for no basis of comparison (a different 5 could be reported in any year).

The requirement to use accounting values to report remuneration is confusing and misleading to shareholders. This results in many organisations trying to "simplify" the same information, but reporting different values to reflect what actually was earned by executives.

2.3 Reducing the complexity of remuneration reporting

The Directors Report and Financial Reports should be treated separately. The Directors Report should be focused on providing a simple outline of company affairs for shareholders, including remuneration, and should not be constrained by accounting standard requirements, which complicate reporting.

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[1] http://www.pc.gov.au/projects/inquiry/executive-remuneration

The Financial Reports should focus on outlining the accounts and financial information in accordance with accounting standards. If this approach is followed, the remuneration in the financial report would be audited, but there would be no need to require an audit of the Remuneration Report, also reducing compliance costs.

Measures to simplify the Remuneration Report should include:

- Reduction in the mandatory disclosures required and clarification of the rationale of the remaining disclosures.
- Development of a clear consistent and logical structure for the remuneration reports which provides an outline of the company's remuneration arrangements in the context of its business environment and strategy, having appropriate regard to disclosure of commercially sensitive information.
- The use of actual/realised values rather than accounting values. To ensure a consistent approach is taken, guidelines need to be provided on defining terms and values to be used.
- Adoption of a "Plain English" approach to the drafting of the remuneration report, for example, adopting the requirement for a disclosure document that the information be "worded and presented in a clear, concise and effective manner (section 715A). However a separate "Plain English" summary should not be mandated, as this merely duplicates the information and does not address the core issue, being simplification of the remuneration report a whole.
- Removal of the requirement to report the 5 highest paid as well as KMPs (as per the Productivity Commission recommendations).

The proposal by Ernst and Young outlined in section 3.2.6 of the CAMAC Information Paper provides a sensible structure and approach to achieving these objectives.

Some further detail on these matters follows.

2.4 Remuneration disclosure requirements for subsidiary entities

Currently disclosure of remuneration is required for all entities that are required to prepare financial reports under the Corporations Act 2001, specifically these entities are:

- Disclosing entities;
- Public companies;
- Large Proprietary Companies; and
- Registered schemes

These types of entities are further defined in the Corporations Act 2001. For a major bank, this can equate to over 100 entities that meet the disclosure requirement.

The vast majority of directors on these companies are employees of the banking group who do not receive specific fees for their services to the boards of these companies, as directors or KMP.

In order to comply with the requirements, directors and KMP are requested to disclose the proportion of their time they spent on matters relating to the respective company and then this portion of their annual remuneration (which they receive from the banking group) is disclosed in the accounts for the entity. The resulting information does not record any specific remuneration paid for most of the directors and KMP whose details are disclosed for these entities, and would provide limited insight for readers of the disclosures.

It is unclear as to what the intention is behind this requirement. We recommend amending the regulations to exempt entities of a consolidated, listed, company which is already required by law to publish a remuneration report, from producing a separate remuneration disclosure.

2.5 Reporting of actual pay

When setting levels of executive remuneration for a given individual in any given year, Boards generally consider the actual pay awarded in relation to the individual's performance, financial results and other factors.

In some organisations however, particularly financial services organisations, deferrals of bonuses are very common. As a result, actual pay received may include current year fixed and short term performance-based remuneration as well as remuneration deferred from the previous years.

Actual pay awarded can be included in the Remuneration Report, however the definition needs to be defined to ensure all organisations interpret it in the same way.

2.6 Reporting paid vs awarded vs expensed remuneration

Paid remuneration is what the executive actually received during the year. This would include cash and shares received across all remuneration components (fixed, STI and LTI[2] etc components).

Awarded remuneration is what the company allocated to the executive during the year, but from which the executive may not have actually benefited yet (e.g. STI awarded where a portion is deferred to a later date).

Expensed remuneration is essentially what is current recorded in the compulsory remuneration table included in remuneration disclosures.

None of these items will include all the remuneration an executive received for the performance of the company during the reporting period, given the different performance periods that are in play across all remuneration components. Also, STI is the only performance-based component that relates to one year's results.

Other payments, like LTI, relate to multiple periods and there will be times when the vesting of these components does not align with the performance of the

[2] STI = short term incentive; LTI = long term incentive

company due to the timing of payments, not the performance that is being measured (which may be different to the performance for the period that is being reported on).

CAMAC should consider what shareholders are seeking in the disclosures to help them form a view about the organisation they hold shares in. For example, do they want to see how much an executive received, or do they want to understand what they received for the performance that the company achieved?

Intuitively, it would be the latter when assessing the governance and performance of the organisation. Other stakeholders and public commentators may be more interested in the former, but one could question the true value that this brings to the main concern over reward for performance and sharing profits between executives, employees and shareholders.

3. Simplification of Incentive Arrangements

Incentive arrangements and structures are proprietary to an organisation and very difficult to simplify. Each organisation has its own complexities, risks and challenges against which to design incentives. The point of commonality is that any organisation should be able to demonstrate that they have considered all aspects of plan design and that there is a clear alignment to shareholder experience/value.

Incentive arrangements need to be tailored to and aligned with the organisation's environment and objectives. Simplification should focus on the tax, accounting and regulatory framework in which incentive plans operate rather than on prescribing a particular approach or structure for incentive arrangements. A focus on a particular structure or approach may in fact create greater complexity, as any prescribed structure or approach will be unable to take into account the full range of circumstances and factors which Boards are required to consider in setting incentive arrangements.

It is also unlikely, that given the range of views evidenced by the submissions to the Productivity Commission, it would be possible to gain a high level of consensus on what such a structure or approach should look like. Any regulation should be consistent with APRA requirements (which are consistent with the Financial Stability Board principles adopted by the G20), and not create yet another regime, and an additional regulatory overlay for financial institutions.

3.1 Incentive design and disclosure

There are areas where better disclosure of why incentive plans are developed could be implemented, including how the results that flow from them reflect performance. However, given the vast range of business structures, priorities and circumstances, a simple one-size-fits-all approach to incentive design will not deliver positive results in all circumstances and could, in some cases, work against the goals of the company.

There could be regulated principles that guide the design of incentives, but it should be up to the business to apply these in their context and communicate how and why they have done this.

Care will need to be taken to ensure incentive design principles are sensitive to commercial needs in a competitive market. Incentive plans deliver payments on business results, but are also designed to influence behaviours and cultural elements which may be best not discussed in an open forum.

3.2 Board discretion

Boards are in the best position to determine appropriate incentive design, and to ensure the payouts are driving business performance and shareholder value.

Boards are best placed to assess level of remuneration and how that is structured, but need to have flexibility to respond to individual company circumstances and changing market conditions.

4. ASIC relief

Companies that operate employee share schemes can find the disclosures and limitations on ownership difficult. ASIC relief from prospectus and other requirements for an employee share scheme is not available if total shareholding exceeds 5%.

ASIC also provides relief from the Corporations Act prohibition against subsidiaries acquiring parent company shares. This relief is critical for funds management businesses which need to acquire shares in their listed parent as part of normal trading by the business' funds (e.g. index funds). As a result, the 5% cap will increasingly create difficulties for listed companies as they deliver more remuneration in the form of shares.

We submit that the cap could be increased with adequate market protection provided through normal substantial holder disclosures.

5. Tax and other issues

One area which needs particular attention is the current tax, accounting and regulatory framework for equity plans as it is significant factor contributing to the complexity of these arrangements. Areas requiring particular attention are:

- The cessation of employment taxing point
- The tax treatment of option plans (tax on vesting rather than exercise)
- The impact of the 75% rule.

The taxation of equity upon cessation is contrary to the intent of aligning performance with shareholder experience. This taxing point encourages some organisations to vest in part or full, equity that is still subject to assurance tests, so that departing employees can meet tax obligations. This can result in an employee receiving value inconsistent with shareholder expectations.

The taxing point issue needs to be resolved to ensure organisations are designing incentive arrangements to align with the shareholder experience, and not to circumvent taxing points or incorporate onerous and often difficult to enforce forfeiture conditions.

We support deferred incentives to be in the form of equity, however the taxing of options at vesting, even if they are "under water", has meant that this reward option has become less attractive - yet it is arguably the instrument that best aligns employee and shareholder interests.

6. Proxy-Advisor and the two strike rule

With the introduction of the two strike rule, the importance of well informed shareholder base is of significantly increased importance.

Quite often the largest shareholder groups are influenced by proxy advisors. It is therefore of paramount importance that disclosure requirements are consistent with the requirements of proxy advisors and other influential shareholder groups so that such groups can accurately assess the disclosures against their marking criteria. Inaccurate marking by proxy-advisors could lead to a spill of the Board.

While it would not be practical to have disclosure to cover the requirements of all such groups, the key ones should be covered.

Disclosures should match as closely as possible proxy advisor criteria and there needs to be a Government-led communication campaign for this group of stakeholders to ensure consistency of approach.