

31 August 2010

Attention: Mr John Kluver
Executive Director
Corporate and Markets Advisory Committee

By Email: john.kluver@camac.gov.au

Executive Remuneration Review

The Australian Council of Superannuation Investors (ACSI) is pleased to provide the following submission to the Corporations and Markets Advisory Committee (CAMAC) following the request from the Hon. Minister Chris Bowen MP for CAMAC to examine the reporting requirements contained in section 300A of the Corporations Act and related regulations. We note that CAMAC has been specifically requested to:

- Examine the existing reporting requirements contained in section 300A of the Corporations Act and related regulations and identify areas where the legislation could be revised in order to reduce its complexity and more effectively meet the needs of shareholders and companies;
- Make recommendations on how best to revise the legislative architecture to simplify the incentive components of executive remuneration arrangements;
- Examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements; and
- Make recommendations on how best to revise the legislative architecture to simplify the incentive components of executive remuneration arrangements.

ACSI represents the interests of 39 superannuation funds who collectively manage over \$250 billion in retirement savings. ACSI provides its members with advice and information on the impact of corporate governance, environmental and social issues on the long term performance of investee companies. On behalf of its members, ACSI discusses these issues with Australia's largest listed companies.

The work ACSI undertakes on behalf of its member funds includes:

- Providing advice to members on the governance practices of listed companies;
- Proxy voting services to assist super funds to exercise their voting rights effectively;
- Engagement with listed companies to improve governance practices;
- Commissioning and producing research on key governance issues; and
- Publicly advocating for improved governance practices, including the promotion of effective legislative and regulatory regimes.

ACSI's interest in the remuneration of directors and CEO's and other Key Management Personnel (KMP's) in listed companies arises from:

- A desire to ensure that boards have in place adequate remuneration mechanisms to motivate CEO's and KMP's to achieve desired behaviours and performance outcomes in the interests of shareholders.
- The view that remuneration provides one of the few visible proxies for shareholders to gain insight into whether boards are exercising effective control and monitoring company executives.
- Recognition of the contribution of non-executive directors for their governance oversight responsibilities.
- The fact that CEO's and senior executives influence the direction of companies, which ultimately affects shareholder returns over the long-term.
- The view that in some cases, poorly designed remuneration structures can contribute to short-termism or excessive risk taking by company executives.

The detail and substance of what is disclosed in a remuneration report is essential for investors to review a company's governance practices, to engage with companies in an informed manner and to determine their vote on a remuneration report. ACSI believes that the introduction of the non-binding vote on remuneration reports in 2005 has been conducive to fostering improved engagement between companies and shareholders on remuneration and corporate governance issues.

Over the past 9 years ACSI has had extensive experience engaging with S&P/ASX200 company boards, and providing advice to its members, on executive remuneration issues. More particularly, ACSI has advised its members on the non-binding remuneration report vote since its introduction in 2005. This experience has meant that we have read, interpreted, engaged on and made recommendations on the contents of a countless number of remuneration reports. Drawing on this experience, ACSI welcomes the opportunity to make the following observations to CAMAC on how current legislative requirements could be revised to reduce complexity and more effectively meet the needs of shareholders:

1. The perceived 'complexity' of remuneration reports is not a product of current reporting requirements. Perceived complexity is often reflective of complex remuneration arrangements designed by listed company boards. ACSI supports the preparation of concise or 'plain English' summaries of remuneration policies, however, efforts to reduce complexity should not result in the removal of important detail from remuneration reports.
2. In ACSI's experience, the majority of listed companies do not meet the requirement of s300A (1)(ba)(i) of the Corporations Act to provide a 'detailed summary' of performance conditions when reporting short term incentives. Clarifying, enforcing and improving compliance with this legislative requirement would significantly improve the quality of remuneration disclosures.
3. ACSI notes that institutional investors understand the difference between fair value estimates of share-based remuneration and the realised value of remuneration received by company executives. ACSI therefore recommends that no change be made to current reporting requirements relating to the disclosure of share-based payments to company executives. Reporting the realised or actual value of share-based payments received by company executives, or total realisable remuneration, is consistent with current legislative reporting requirements. Including aggregate 'realisable remuneration' or 'actual values' of share-based payments received in remuneration reports may be useful when reporting summary remuneration outcomes but should not replace current reporting requirements.
4. ACSI notes that there is often a discrepancy between contractual termination entitlements disclosed under s300A(1)(e)(vii) and the payments actually received by executives. ACSI therefore supports the introduction of a requirement for companies to report the maximum value of termination pay on an *ex ante* basis which would allow investors to compare estimated termination benefits with actual termination benefits received. ACSI also recommends that companies be required to disclose the contractual provisions that gave rise to the relevant termination or retirement payment, at the time the payment is made, as another way in which s300A could be amended to more effectively meet the needs of shareholders.
5. ACSI recommends CAMAC reject submissions calling for an increase in the threshold requiring companies to seek shareholder approval for executive termination payments included in ss200AA-J of the Corporations Act.
6. Simplifying the incentive components of executive remuneration arrangements through the 'legislative architecture' is difficult without imposing prescriptive requirements. ACSI believes that company boards are best placed to create remuneration structures which may be simple or complex depending on the objectives of the company. ACSI is therefore opposed to the introduction of prescriptive legal or regulatory arrangements aimed at simplifying the components of executive remuneration.
7. If it is thought that the 'remuneration setting framework' should provide more guidance on remuneration practices, outside of prescriptive legal requirements, ACSI suggests that guidance and 'if not, why not' recommendations could be produced by the ASX Corporate Governance Council to indicate what is considered 'good practice'.

1. Reducing complexity in remuneration reports

ACSI contends that a 'dual method' of presenting information contained in a remuneration report is one way to reduce perceptions of complexity. A 'dual method' of reporting would include the preparation of a concise or 'plain English' summary of remuneration practices coupled with the more detailed presentation of relevant details required by the Corporations Act and relevant regulations.

A threshold question is – for what audience are remuneration reports prepared? The perception of complexity for institutional investors may be very different to a reader with low financial literacy. ACSI notes that perceptions of complexity in reporting are often reflective of the complex remuneration arrangements designed by listed company boards rather than legislative reporting requirements. The financial statements of a listed company would appear complex to the average reader but few would recommend that complex financial details be removed from company reports simply to improve readability. ACSI does not support efforts to reduce complexity which would result in the removal of important detail from remuneration reports.

ACSI notes that 'plain English' summaries of remuneration practices may reduce the perception of complexity amongst some investors. ACSI is supportive of the efforts of companies to provide a 'plain English' overview of remuneration practises, such an approach may include:

- Remuneration objectives, in particular the link between incentives and company strategy and performance objectives;
- Explanation on the alignment of remuneration arrangements with shareholder interests;
- Rationale for fixed pay levels complemented with explanations for movements in fixed pay for executives;
- A detailed summary of performance requirements for short term and long term incentives; and
- Termination payment arrangements which are applicable.

Since the introduction of the non-binding vote on remuneration reports in 2005, ACSI has encouraged listed companies to improve their narrative approach to reporting by striking a balance between meeting legislative reporting requirements and providing explanations for why specific remuneration arrangements have been employed. We note that a narrative approach to reporting, and the preparation of a 'plain English' summary of remuneration practices, are not precluded by the existing provisions of s300A of the Corporations Act.

As noted in detail below, ACSI supports current reporting requirements and the provision of detailed information in remuneration reports. ACSI also notes that some remuneration reports are complex, but such complexity largely reflects the nature of the remuneration arrangements endorsed by company boards that are considered appropriate depending on the objectives of the company.

Recommendation:

ACSI supports the disclosure of concise or 'plain English' summaries of remuneration practices where they are complemented by the provision of a more detailed account of remuneration arrangements. The disclosure of detailed remuneration arrangements is an essential requirement for institutional shareholders to evaluate remuneration reports.

2. Short term incentive ('STI') disclosures

In examining the existing reporting requirements contained in section 300A of the Corporations Act, ACSI recommends that CAMAC consider the requirements of ss300A(1)(ba)(i-iii) for listed companies to provide information on performance conditions where an element of executive remuneration is performance based. ACSI notes that the disclosures provided by a significant number of companies do not meet the requirements of ss300A(1)(ba). Where an element of the remuneration of a member of the key management personnel is dependent on the satisfaction of a performance condition, companies must disclose:

- a detailed summary of the performance condition¹;
- an explanation of why the performance condition was chosen²;
- a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen³; and
- if the performance condition involves a comparison with factors external to the company, a summary of the factors used in making the comparison including relevant comparator group of companies if relevant⁴.

We note that among the submissions made to the Productivity Commission's inquiry, several groups noted widespread non-compliance with the requirement for companies to provide a 'detailed summary' of performance conditions under s300A.⁵ The Productivity Commission's own research demonstrated that 'in 2007-08, only one of the top 20 companies disclosed the actual performance hurdle for payment of (some) short-term incentives⁶ and remuneration reports 'provide little, if any, information about short-term incentive hurdles, which are more likely to relate to internal and, therefore, commercially sensitive, indicators'⁷.

Recent research conducted by ACSI into the reporting of short term incentives in S&P/ASX50 companies indicates that only 21% of the remuneration reports prepared by S&P/ASX50 companies in 2009 appear to

¹Corporations Act, s300A(1)(ba)(i).

²Ibid, s300A(1)(ba)(ii).

³Ibid, s300A(1)(ba)(iii).

⁴Ibid, s300A(1)(ba)(iv)(A).

⁵ See, for example, ACSI, Submission No 71 to Productivity Commission, *Executive Remuneration Inquiry*, 6 June 2009, p8; Egan Associates, Submission No 105 to Productivity Commission, *Executive Remuneration Inquiry*, 14 September 2009, p19; RiskMetrics, Submission No 58 to Productivity Commission, *Executive Remuneration Inquiry*, 25 September 2009, p12; and Guerdon Associates and CGI Glass Lewis, Submission 80 to Productivity Commission, *Executive Remuneration Inquiry*, 10 June 2009, p8.

⁶Productivity Commission, *Executive Remuneration in Australia, Final report No.49* (2009), Table 7.4, p204.

⁷Ibid, p375.

comply with statutory requirements to disclose a 'detailed summary' of performance conditions where remuneration is performance based. These findings are in line with research provided by remuneration consultancy firm Guerdon Associates which indicates that fewer than 20% of ASX 300 companies comply with s300A reporting requirements.⁸ Proof that non-compliance with these standards is not a new phenomenon; Guerdon Associates' best estimates are partly based on research into the reporting practices of the S&P/ASX50 for the 2006 year.⁹

Commercially Sensitive Information

ACSI is aware of concerns around the disclosure of commercially sensitive performance hurdles, specifically where companies would have to disclose commercially sensitive forward-looking profit or earnings targets. While we acknowledge the issue of commercial sensitivity, this does not appear to be an impediment for two reasons. Firstly, the reporting requirements included in ss300A(1)(ba)(i-iii) are retrospective and the remuneration reports of listed companies reflect performance over the previous financial year. Secondly, the requirements ss300A(1)(ba)(i-iii) do not appear to require disclosure of specific forward-looking performance hurdles or targets, or the minutiae of STI results for each senior executive. We also note that the current wording of s300A appears to provide what the Productivity Commission defined as 'ample scope'¹⁰ for companies to summarise performance requirements without disclosing commercially sensitive details.

Current STI Reporting Practices

ACSI notes that a significant proportion of companies provide STI disclosures which include general statements such as 'short term incentives were determined with regard to a range of financial and non-financial measures determined by the board'. Another defining feature of many remuneration reports is the lack of STI performance metrics or 'detailed summaries' of performance conditions. Often disclosures provide a grab-bag of general performance areas without an indication of any performance measures used, or the proportion of STI attributable to each performance measure or outcome. Two examples of this type of disclosure are:

'At the commencement of each financial year the Board approves the Managing Director's performance objectives and ensures that they are consistent with Board approved corporate objectives... Performance objectives include a blend of financial, corporate and individual objectives and typically include targets in relation to contribution to earnings, the successful implementation of strategic initiatives, management of operating expenses, customer service, risk management, market share and portfolio management'¹¹

And;

A range of Company performance measures is used in order to drive balanced business performance. These measures include lagging indicators to assess the Company's past performance, as well as forward-looking indicators to ensure the Company is positioning itself effectively for future growth. The areas covered by the measures include reserve growth, reserve replacement cost, production, margin, new growth options, shareholder value creation, people, environment, health and safety, and continuous improvement¹².

These examples demonstrate the difficulty for shareholders in assessing how STI bonus outcomes are arrived at based on the information disclosed in remuneration reports. ACSI's view is that providing an exhaustive list of performance conditions (which may or may not have a connection to STI outcomes) does not meet the needs of shareholders and contributes to 'complexity' in remuneration reports. Simple, retrospective disclosure of short term incentive conditions would reduce complexity in remuneration reports and improve the level of detail provided to shareholders.

Options for reform and policy implications

ACSI notes that despite having been put in place six years ago, regulators and policymakers have not clarified the requirements of s300A(1)(ba). A simple action which would improve compliance with this provision would be to have ASIC clarify and produce guidance for listed companies on these disclosure requirements. It has been noted elsewhere that having ASIC clarify and enforce remuneration reporting requirements is not without precedent.¹³ One example occurred in 2004, where ASIC provided guidelines on valuing options in annual directors' reports which were later integrated in the *Corporations Act*¹⁴. Research undertaken elsewhere with

⁸ Guerdon Associates and CGI Glass Lewis, Submission 80 to Productivity Commission, *Executive Remuneration Inquiry*, 10 June 2009, p58.

⁹ Guerdon Associates, *Disclosures and Compliance – What Compliance?* (June 2007) <<http://www.guerdonassociates.com/News-Detail.asp?cid=69&navID=4&NewsID=179>>.

¹⁰ Productivity Commission, *Executive Remuneration in Australia, Final report No.49* (2009), p375.

¹¹ CSL Limited, *Annual Report 2009*, p43.

¹² Santos Limited, *Annual Report 2009*, p59.

¹³ See, for example, RiskMetrics, Submission No 58 to Productivity Commission, *Executive Remuneration Inquiry*, 25 September 2009, 12.

¹⁴ Ibid. See ASIC, *Information Release 05-42 Changes to ASIC class orders, practice notes and guidelines relating to new financial reporting requirements*, (27 July 2005) <<http://www.asic.gov.au/asic/asic.nsf/byheadline/03-202+Valuing+options+for+directors+and+executives+?openDocument>>

regard to continuous disclosure provisions has shown a link between ASIC enforcement activity and increased levels of compliance by listed companies¹⁵.

ACSI notes that current reporting practices pose significant barriers to the introduction of the Government's 'clawback' proposal announced in response to the recommendations of the Productivity Commission. This proposal would introduce a clawback of executive bonuses where it is revealed that financial statements are materially misstated.¹⁶ The clawback proposal is aimed at increasing the ability for shareholders to recover 'overpaid bonus amounts' from directors and executives based on the premise that they 'may have received larger bonuses as a result of the company's artificially high share price'¹⁷. ACSI notes that a significant majority of STI disclosures give no indication as to the proportion of an STI award which is attributable to specific performance conditions or outcomes. This means that it is virtually impossible to assess an 'overpaid bonus amount' as it cannot be determined what proportion of STI bonus outcomes were contingent on performance outcomes linked with misstated financial statements. The only option available would be to 'clawback' entire STI awards paid during periods where it is revealed that financial statements are materially misstated, even where bonuses may have been unrelated to the misstated financial results, such as outcomes linked to non-financial performance.

While noting that APRA's guidance and regulatory powers are separate from the remuneration reporting requirements of the Corporations Act, and are only applied to some listed financial institutions, ACSI notes that opaque disclosure of STI performance conditions amongst listed companies is inconsistent with the principles contained in APRA's Prudential Practice Guide on remuneration¹⁸. While there is extensive discussion of risk controls in the remuneration reports of many listed APRA regulated entities, there is a question of how these risk considerations translate into performance conditions. The disclosure of a detailed summary of STI performance conditions is therefore relevant to APRA's work in encouraging financial institutions to consider risk in executive remuneration structures¹⁹.

Recommendation:

ACSI recommends that CAMAC review the operation of ss300A(1)(ba)(i-iii) in order to address the low level of compliance with these statutory reporting requirements, particularly where companies report short term incentives for senior executives. Such a review should reaffirm adherence to current legislative requirements, and encourage where possible the retrospective disclosure of STI performance conditions. ACSI notes that opaque disclosures give shareholders almost no indication of the performance conditions upon which short term incentive awards are based. ACSI believes that clarifying, enforcing and improving compliance with ss300A(1)(ba)(i-iii) would significantly improve remuneration disclosures and ensure remuneration reports continue to meet the needs of shareholders.

3. Remuneration tables and the disclosure of share-based payments

ACSI would like to comment on the current debate concerning the valuation and disclosure requirements relating to long term incentives, and specifically share-based payments. One argument put forward is that reporting should be confined to 'actual pay' as opposed to 'reporting theoretical accounting valuations of remuneration'²⁰. We note that the current requirements for reporting long term incentives and share-based remuneration were well documented in the final report of the *Productivity Commission*.²¹

Observations on the disclosure of share-based payments

ACSI notes the problems with relying solely on the reported values of share based-payments granted to senior executives. Under the current regulatory framework, companies are required by accounting standard AASB 2 *Share-based Payment* to report on the estimated fair value of share-based incentives based on a range of accounting measures. These standards can give rise disclosures where there is a significant difference between reported and realised remuneration.

For example, the fair value of share options granted to a senior executive can be far below the 'actual' or realised value received by the executive when options are exercised. A recent example of 'undervaluation' were the 225,000 shares granted to BHP Billiton CEO Marius Kloppers on 3 December 2004, which vested in full in

¹⁵ M Welsh, 'Continuous Disclosure: Testing the correspondence between state enforcement and compliance' (2009) 23 *Australian Journal of Corporate Law* 206.

¹⁶ See Australian Government, *Response To the Productivity Commission's Inquiry on Executive Remuneration in Australia*, (April 2010), p17. <<http://mfsscl.treasurer.gov.au/Ministers/ceba/Content/pressreleases/2010/attachments/033/033.pdf>>.

¹⁷ *Ibid*.

¹⁸ Australian Prudential Regulatory Authority (APRA), *Prudential Practice Guide – PPG115 Remuneration*, 30 November 2009.

¹⁹ *Ibid*.

²⁰ Australian Institute of Company Directors (AICD), *Position Paper No15: Remuneration Reports* (June 2010).

²¹ See Productivity Commission, *Executive Remuneration in Australia, Final report No.49* (December 2009), pp259-261, 342-344, and Appendix E Valuing equity-based payments.

August 2009. The fair value given to the grant in 2005 was £2.63GBP per share²² or a total of £591,750, the realised value at 12 August 2009 was £15.55²³ per share or a total of £3.499million – this is almost six times the fair value disclosed in 2005. We note that in this case BHP Billiton provided a comprehensive explanation of this difference to shareholders, reiterating the long-term performance conditions which were achieved allowing the grant to vest.

Another example of ‘undervaluation’ was at Suncorp-Metway Limited (‘Suncorp’) where the 247,920 shares granted to former CEO John Mulcahy in January 2003 vested on 5 January 2008. The fair value of the original grant was disclosed as \$2.138 million ‘assuming all performance criteria are met’.²⁴ The realised value of the 80% of shares which vested, as on the first trading day after 5 January 2008 was \$4.029 million, almost twice the fair value disclosed in 2003²⁵.

Another example from Suncorp demonstrates the potential for fair value estimates to ‘over report’ share-based payments. When John Mulcahy departed Suncorp in 2009 he forfeited 227,261 zero exercise price options (ZEPO’s) which had a previously disclosed fair value of \$5.656 million.

The potential for the estimated fair value to either overstate or understate the realised value of incentives is something of which institutional investors are aware. As an organisation that provides corporate governance advice to its member superannuation funds, which includes making recommendations on the remuneration reports of S&P/ASX200 companies, ACSI has never made a recommendation based exclusively on a ‘theoretical’ or fair value estimation of share-based payments. We judge the remuneration reports prepared by listed companies based on the realised value of incentives paid to executives and the expected value of incentives which have been granted. Our main focus is on the appropriateness of performance conditions attached to share-based payments.

ACSI is unaware of any institutional investors, or proxy advisors, who would judge a company based on the fair value of long term incentives where options are clearly underwater and performance conditions have not been (or are unlikely to be) met. It appears that this concern has arisen in the current climate where, in some cases, fair value estimates ‘over report’ actual remuneration. ACSI is mindful that this concern has not been expressed during periods of growth where equity based remuneration were often under reported. The media misreporting fair value estimates as ‘take home pay’ is another justification provided for removing requirements to value equity-based remuneration²⁶. The accuracy of media articles should not drive reform in remuneration reporting, as institutional investors do not judge remuneration reports based on media articles. It is not clear that adjusting current reporting requirements will deal with isolated cases of misreporting. For example, reporting of aggregated amounts of ‘realisable remuneration’ may be equally likely to lead to misreporting²⁷.

In ACSI’s view, suggested amendments to current reporting requirements that limit disclosure of share-based payments to the ‘actual value’ when an employees remuneration crystallises, would reduce transparency²⁸. This type of reporting could make remuneration reports extremely retrospective – with the value of long term incentives only being disclosed 3, 4 or 5 years *after* a grant date, if at all. It is ACSI’s strong opinion that such proposals would create remuneration reports which would not meet the needs of shareholders who wish to vote and engage with companies on an informed basis.

Remuneration Tables

ACSI notes that several groups have proposed modifications to statutory remuneration tables. Whilst commendable in intent, we remain concerned that proposed changes could potentially make remuneration reports longer and more complex, without the provision of adequate detail for institutional shareholders. ACSI is concerned that proposed changes to introduce reporting of the ‘actual value’ of remuneration may serve to create more complexity and confusion for shareholders²⁹.

Ernst & Young have provided a suggested ‘ideal’ remuneration report³⁰. This suggested framework would have companies report ‘Equity incentive opportunities (expressed as a dollar value or a percentage of fixed remuneration with an explanation regarding how this is converted into a number of shares/rights/options)’ in a section detailing a summary of each executive’s remuneration opportunity for the year. In a separate section of the remuneration report, companies would report ‘actual remuneration’ including ‘share-based payments that

²² BHP Billiton Limited, *2005 Financial Report*, (August 2005), p70.

²³ Based on the BHP Billiton PLC share price on 12 August 2009. This does not include additional dividend accrual value.

²⁴ Suncorp-Metway Limited, *Annual Report 2006*, p45 noted in ACSI, *CEO Pay in the Top 100 Companies: 2009*, (Research report prepared by ISS Governance Services, July 2010).

²⁵ Suncorp-Metway Limited, *Annual Report 2007/08*, p17. The closing share price on 7 January 2008 was \$16.25.

²⁶ See, for example, Ernst & Young, *Submission No 2 to the CAMAC Review on Executive Remuneration*, 13 August 2010, p3.

²⁷ Guerdon Associates, *Submission No to the CAMAC Review on Executive Remuneration*, 13 August 2010, p16.

²⁸ See, for example, Australian Institute of Company Directors (AICD), *Position Paper No15: Remuneration Reports* (June 2010).

²⁹ This point was noted by KPMG. KPMG, *Submission No 15 to the CAMAC Review on Executive Remuneration*, 23 August 2010, p9.

³⁰ Ernst & Young, *Submission No 2 to the CAMAC Review on Executive Remuneration*, 13 August 2010, p5.

vested during the year (i.e., where there is no longer a “real risk of forfeiture”, although disposal restrictions may still apply). Depending on the detail of equity incentive opportunities, this framework for disclosure would still rely on fair value estimates of share-based remuneration but appears to limit disclosures to the share-based remuneration granted in the reporting year. It is unclear how this would improve current reporting requirements. ACSI notes that companies are already able to provide information on the ‘realised’ or ‘actual’ value of share-based payments received under the current legislative framework. Under the current framework, companies are also able to comment on the likelihood that the performance conditions attached to share-based remuneration will be met.

As noted in *Ernst & Young’s* submission, the disclosure of the ‘actual value’ of share-based payments can create an appearance of a disconnect between performance and payment³¹. This is due to the fact that the ‘actual value’ of share-based payments that vest in a given year may reflect performance over a number of years. ACSI notes that this proposal could serve to increase the possibility of misinterpretation by shareholders and that reporting fair value and ‘actual values’ of share-based remuneration in separate sections of a remuneration report could also add to the complexity of remuneration reports, and may not provide greater clarity for shareholders. ACSI recognises that a number of companies already disclose the actual value of vested share-based remuneration received by executives under the current legislative reporting framework.³²

Guerdon Associates have prepared a proposed amendment to the Corporations Regulations which includes the reporting of realisable remuneration and grants received³³. These proposed amendments would mandate the reporting of two remuneration tables. The first table would record the ‘realisable remuneration’ received by senior executives during the reporting year. This approach appears to require reporting an aggregate amount of remuneration received including share-based payments realisable during the relevant year, fixed pay, short term incentives, and any termination benefit received during the year. The proposed amendment also requires the disclosure of a table of ‘grants received’ which appears to be very similar to current legislative reporting requirements – although the disclosure of long term incentives appears to be limited to fair value estimates for grants made during the relevant reporting period only.

Reporting ‘realisable remuneration’ or ‘actual values’ may be helpful for retail investors and other stakeholders, who may not understand the difference between fair value estimates of share-based payments and the actual value of share-based payments on vesting. As noted above, such disclosure is consistent with the current legislative reporting requirements. ACSI is concerned that adding to current disclosure requirements may create further complexity in reporting share-based remuneration. The preparation of two separate remuneration tables has the potential to create more confusion amongst investors, particularly where an aggregate amount of ‘realisable remuneration’ is reported in addition to a summary of grants received. In ACSI’s opinion, it may be more difficult for retail investors to reconcile two separate tables of ‘realisable remuneration’ and ‘grants received’, than for investors to interpret current remuneration reporting tables.

ACSI asserts that there are no barriers in the current legislative framework for companies to report on ‘actual remuneration’ received during a reporting period and comment on the expected value of long term incentives including share-based payments. In ACSI’s opinion, the valuation issues noted above do not warrant modifying current reporting requirements as institutional investors are able to make informed decisions based on the information which is currently included in remuneration reports taking into account fair value estimates, and the actual or realised value of share-based remuneration.

Recommendation:

Reporting the actual value of share-based payments received by company executives or total realisable remuneration is consistent with current legislative reporting requirements. We recognise that including aggregate ‘realisable remuneration’ or ‘actual values’ of share-based payments received in remuneration reports may be useful when reporting summary remuneration outcomes, this may be particularly useful for retail investors. In ACSI’s opinion, such disclosures are unnecessary for institutional investors who are able to make informed judgments on share-based payments based on what is currently disclosed. ACSI recommends that no change be made to current reporting requirements relating to the disclosure of share-based payments to company executives.

4. Disclosure of termination arrangements

ACSI also notes several issues relating to the reporting of contractual termination entitlements for key management personnel required under s300A(1)(e)(vii) of the Corporations Act. In recent years we have noted

³¹ Ernst & Young, *Submission No 2 to the CAMAC Review on Executive Remuneration*, 13 August 2010, p6.

³² See, for example, Transfield Services Limited, *2009 Annual Report* (October 2009), pp50-60.

³³ *Guerdon Associates, Submission No to the CAMAC Review on Executive Remuneration*, 13 August 2010, p16.

that the payments received by executives on termination often do not reflect the previously disclosed termination payments provided for under the relevant executive's contract. Two recent examples are:

- **Downer EDI Ltd:** the disclosure of the termination payment received by outgoing CEO Geoffrey Knox, who resigned on 30 July 2010, noted that Knox was eligible to receive 243,103 shares on termination which were granted under the company's 2008 long term incentive scheme³⁵. These long term incentives were never subject to shareholder approval and despite the requirements of s300A(1)(e)(vii), the treatment of these incentives was never disclosed by the company; and
- **Aristocrat Leisure Ltd:** where the former CFO, and executive director, Simon Kelly left the company on 31 July 2009. On termination Kelly received:
 - A bonus payment of \$400,000 under a 'deed of release' in recognition of a 'prior contractual obligation' and 'retention arrangements'³⁶.
 - A further bonus of \$120,723 for the part of the 2009 financial year served reflecting the "bonus he would have been entitled to in 2009 if his employment had continued for the full year" reduced to reflect the portion of the year served³⁷.
 - Termination payments of \$1.13 million³⁸.

Kelly's total termination payments were therefore \$1.65 million (more than 1 percent of Aristocrat's 2009 operating cash flow) and more than twice Kelly's reported remuneration for the 2008 year. This payment appeared to be in excess of contractual termination entitlements disclosed in the 2008 remuneration report which allowed for a notice period of three months, or payment in lieu, and a termination payment equivalent to nine months' remuneration³⁹. The report did not disclose any entitlement to retention payments or a bonus on termination.

These examples highlight the gap between contractual entitlements disclosed under s300A(1)(e)(vii) and the actual termination payments received by departing executives. Another related issue is that according to information disclosed to the ASX, very few senior executives are terminated. In many cases, the resignation⁴⁰ or mutually agreed termination⁴¹ of executives also trigger termination entitlements which may have little connection with the contractual termination entitlements reported under s300A(1)(e)(vii). The amendment of s200AA-J requiring shareholder approval for termination entitlements that exceed one year's base salary should serve to improve transparency in cases where termination entitlements are put to a shareholder vote. However, we note that this provision does not apply to pre-existing contracts and even where contracts are approved by shareholders there may still be discrepancies between disclosed remuneration entitlements and actual remuneration received by executives on termination.

The cases noted above show the potential for discrepancy between contractual termination entitlements disclosed under s300A(1)(e)(vii) and the payments actually received by executives. CAMAC may wish to consider the current operation of s300A(1)(e)(vii) as part of its review. ACSI is supportive of proposals to improve the transparency around termination entitlements. Requiring companies to disclose the contractual provisions that gave rise to the relevant termination or retirement payment, at the time the payment is made, is one way in which s300A could be amended to more effectively meet the needs of shareholders.

Another improvement to the reporting of termination payments under s300A(1)(e)(vii) would be a requirement for companies to disclose the estimated value of termination payments *ex ante*. This would require companies to disclose the estimated value of incentives (both cash and share-based) that the executive would have received on termination, retirement or resignation as at the reporting date. This would allow investors to compare the estimated value of termination and retirement benefits, as included in *ex ante* disclosure, with actual termination or retirement benefits received.

Recommendation:

ACSI notes that there is often a discrepancy between contractual termination entitlements disclosed under s300A(1)(e)(vii) and the payments actually received by executives. ACSI therefore supports the introduction of a requirement for companies to report the maximum value of termination pay on an *ex ante* basis which would allow investors to compare estimated termination benefits with actual termination benefits received. ACSI also recommends that companies be required to disclose the contractual provisions that gave rise to the relevant termination or retirement payment, at the time the payment is made, as another way in which s300A could be amended to more effectively meet the needs of shareholders.

³⁵ Downer EDI Limited, *GRANT FENN APPOINTED NEW MANAGING DIRECTOR AND CEO*, (ASX Release, 2 August 2010), p7.

³⁶ Aristocrat Leisure Limited, *2009 Annual Report* (25 March 2010), p37.

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ Aristocrat Leisure Limited, *2009 Annual Report* (25 March 2010), p37.

⁴⁰ See, for example, Downer EDI Limited, *GRANT FENN APPOINTED NEW MANAGING DIRECTOR AND CEO*, (ASX Release, 2 August 2010), p1.

⁴¹ See, for example, David Jones Limited, *Departure of CEO*, (ASX Release, 18 June 2010), p1.

5. Termination benefits

ACSI rejects submissions that seek to repeal recent amendments to the Corporations Act to increase the threshold requiring companies to seek approval for executive termination payments⁴². ACSI notes that the legislation was introduced as a consequence of the excessively high threshold of seven times remuneration that applied previously. The 12 month base pay threshold introduced by the *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009* (Cth) actually reflects the practices of the majority of ASX 200 companies.

ACSI notes that this threshold does not represent a 'cap' on termination benefits. The provision simply requires companies to convince their shareholders that payments over twelve month's base salary are appropriate. Accordingly, ACSI's member superannuation funds and other investors are able to would review these proposals on a case by case basis.

Current legislative requirements have been in place for barely twelve months, yet there have been claims made that these changes have led to an increase in fixed pay amongst executives despite that fact the absence of empirical evidence to support such a claim. Raising the threshold is inconsistent with the expectations of Australian institutional shareholders. Specifically, investors expect remuneration to be linked to long-term performance. Shareholders do not benefit from termination payments which provide reward for failure.

Recommendation:

ACSI recommends CAMAC reject submissions calling for an increase in the threshold requiring companies to seek shareholder approval for executive termination payments included in ss200AA-J of the Corporations Act.

6. The case for simplifying incentive components of executive pay through the legislative architecture

Simplifying the incentive components of executive remuneration arrangements through the 'legislative architecture' is difficult without imposing prescriptive requirements. ACSI believes that company boards are best placed to create remuneration structures which may be simple or complex, depending on the objectives of the company.

ACSI does not believe that it should be the role of the Government or Government agencies to prescribe remuneration design requirements that could potentially impose arbitrary designs aimed at 'simplifying incentives' that are not suited to a company's objectives. We note that there are a range of possibilities and configurations that will determine the design and impact of short and long term incentives. The consideration of these issues requires remuneration committees, and boards, to be mindful of the needs of the company to attract and retain executives, and to reward executives for genuine outperformance.

Additionally, we believe that there is a responsibility on shareholders, in particularly institutional investors, to apply scrutiny to incentive plans. This is why effective disclosure is important, and why ACSI encourages companies to engage directly with institutional investors on remuneration issues. ACSI believes that it is company directors and in particular non-executive directors who are best positioned to make these determinations.

Recommendation:

Simplifying the incentive components of executive remuneration arrangements through the 'legislative architecture' is difficult without imposing prescriptive requirements. ACSI believes that company boards are best placed to create remuneration structures which may be simple or complex depending on the objectives of the company. ACSI is therefore opposed to the introduction of prescriptive legal or regulatory arrangements aimed at simplifying the components of executive remuneration.

7. The case for revising the existing 'remuneration setting framework' in order to simplify incentive components of executive remuneration arrangements

ACSI notes that separate from the Minister's request for CAMAC to make recommendations on how best to revise the legislative architecture, CAMAC has also been requested to examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements. We take this to mean an examination of remuneration setting mechanisms outside the legislative framework. While ACSI sees that there is no merit in imposing prescriptive

⁴² See AICD, *Submission No 3 to the CAMAC Review on Executive Remuneration*, 13 August 2010, p5; and Origin Energy, *Submission No 17 to the CAMAC Review on Executive Remuneration*, 24 August 2010, p5.

legal requirements aimed at 'simplifying' the components of executive incentives, there may be scope for the preparation of guidance on accepted 'good practices' in remuneration.

We note that several groups publish guidance on executive remuneration practices and remuneration reporting. As included in CAMAC's information paper – ACSI, the ASA, IFSA and the AICD have all produced guidance on what is considered 'good practice' in executive remuneration by each group's respective constituents.

If it is thought that the 'remuneration setting framework' should provide more guidance on remuneration practices, outside prescriptive legal requirements, ACSI suggests that guidance could be produced to indicate what is considered 'good practice'. The best source for this guidance would be the ASX Corporate Governance Council *Principles and Recommendations* which operate under an 'if not, why not' reporting requirement and also provide general guiding principles which listed companies can refer to. At present, Principle 8 of the ASX Corporate Governance Council *Principles and Recommendations* provides some general guidance on remuneration issues and makes direct reference to the reporting requirements set out in s300A of the Corporations Act.

Recommendation:

If it is thought that the 'remuneration setting framework' should provide more guidance on remuneration practices, outside prescriptive legal requirements, ACSI suggests that could be produced to indicate what is considered 'good practice'. Such guidance could be provided by the ASX Corporate Governance Council *Principles and Recommendations* which operate under an 'if not, why not' reporting requirement and also provide general guiding principles which listed companies can refer to.

Conclusion

In summary, ACSI believes that, with the exception of short term incentive disclosures, Australia's current legislative framework for the disclosure of executive remuneration in listed companies generally operates in a way which meets the requirements of institutional shareholders. We strongly contend that any attempts to create simplified or summary disclosures should not replace the disclosure of detail for institutional investors. We reiterate that there is scope to alter the current legislative provisions to reduce complexity and ensure remuneration reports continue to meet the needs of shareholders.

Do not hesitate to contact us if you would like to discuss the contents of this submission or require further detail.

Yours Sincerely



Ann Byrne
Chief Executive Officer