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ASA Submission: CAMAC - Executive remuneration

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The Australian Shareholders' Association (ASA) has long been critical of the levels of remuneration paid to executives of listed Australian companies. Through its policy program, company monitoring and proxy voting activities the ASA seeks to improve the outcomes in relation to executive remuneration to benefit the owners of listed companies.

About the ASA

The ASA is a not-for-profit organisation formed to represent, protect and promote the interests of investors in shares, managed investments, superannuation and other financial investments.

The ASA company monitoring program monitors the performance and corporate governance of most of the ASX 200 companies in Australia. In addition the ASA accepts appointments as proxy at the meetings of those companies it monitors. In 2009 the ASA held proxies for approximately $4.3 billion worth of shares.

As a holder of open proxies the ASA decides how to vote those proxies on the resolution to approve of the remuneration report. The ASA decides how to vote those open proxies in accordance with its policy, *Executive Remuneration* (see *Appendix A*).

ASA participation in the Productivity Commission inquiry into Executive Remuneration

The ASA made two written submissions to the Productivity Commission (PC) inquiry and appeared at both the initial hearing and the hearing in response to the Commission's discussion draft.

Complexity of remuneration reports stems from the inherent complexity of the remuneration structures, but also from a lack of commitment to ensuring that the report is a document to communicate with shareholders rather than simply to comply with the legislation. As a result retail shareholders, in particular, find the reports impenetrable.

The narrative section of the reports are frequently difficult to read without a level of expert understanding, whilst the tables generally contain information which is only understood by experts and is not explained in plain English. Rarely do the reports actually appear designed to communicate with shareholders.

Section 300A and related regulation

Reducing the number of items of disclosure required by section 300A may have the effect of simplifying reports by reducing length. This however will not automatically lead to better reports. Removing disclosure which is complex and replacing it with no information will not be an improvement for shareholders.

The consultation paper refers to submissions made to the Productivity Commission by Ernst and Young (EY) and jointly by Allans Arthur Robison, Guerdon Associates, CGI Glass Lewis and Regnan specifically with regard to the simplification of section 300A.[1]

Both of these submissions suggested requiring companies to report actual, or realisable remuneration, instead of accounting values. The approach of providing accounting values of equity based remuneration can confuse shareholders who want to understand what remuneration has been actually paid to executives during the year. This suggestion was a final recommendation of the PC and is supported by the ASA.

Both of the submissions referred to offer suggestions for streamlining the information provided in the remuneration report. The ASA has approached section 300A in a similar manner, suggesting below areas of which could be improved, included and removed.

Improve:

- **Information about comparators**

Section 300A requires that where a performance measures are comparative, that the identity of comparator companies is identified[2]. This requirement needs to be retained. The use of relative measurements can only assist shareholders when the details are transparent and appropriateness of comparators can be assessed.

Remuneration reports frequently refer to benchmarking against comparator companies in order to determine fixed remuneration, without providing any information about those comparators. Where relying upon benchmarking to justify fixed remuneration, reporting entities should identify those comparators in order for shareholders to assess whether they are appropriate.

- **Compare performance and remuneration**

Reporting entities are currently required to discuss company performance, where remuneration is performance based. Section 300A currently requires that:

"(1AA) Without limiting paragraph (1)(b), the discussion under that paragraph of the company's performance must specifically deal with:

(a) the company's earnings; and

(b) the consequences of the company's performance on shareholder wealth;

in the financial year to which the report relates and in the previous 4 financial years." [3]

Subsection 1AB goes on to note that regard should be had to dividends, the changes in share price over the reporting period and any return of capital. There is no requirement that the information provided is consistent over the five years. The reporting entity is able to choose which metrics it uses to discuss company earnings and the consequences for shareholder wealth.

Shareholders would be more likely to receive a genuine reflection of performance if all reports set out the same measure of performance, in a graph, which also set out CEO total remuneration for the same period. In order to avoid the risk that by prescribing the information, the true picture might be lost in some limited circumstances, the narrative would provide an opportunity to discuss any anomalies and provide further information. The ASA would favour a graph setting out total shareholder return and CEO total remuneration over a period of five years.

- **Details of performance conditions**

Section 300A currently requires the following information to be provided with regard to performance conditions:

"(i) a detailed summary of the performance condition; and

(ii) an explanation of why the performance condition was chosen; and

(iii) a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen;" [4]

Share holders are particularly interested in how the incentive plan is designed to:

- Align the time horizons of executives with those of investors in the company, with the long term and short term strategies of the company
- Encourages sustainable long-term earnings.

Whilst remuneration reports frequently state that the various incentive plans employed are designed to achieve these ends, detailed discussion is generally absent. Amending section 300A to require reporting entities to address these issues could both:

- Focus remuneration committees, consultants and others on the shareholder focussed outcomes which plans should be designed to achieve
- Allow shareholders to decide whether the company has genuinely designed any such plans with outcomes for shareholders as the primary motivation.

Include:

- **Risk**

Performance based remuneration comes with inherent risks. The risks which should be addressed include the risk that excessive payments could be made and that awards may vest for performance which is not able to be sustained. The remuneration report should include information about the potential risks of the particular incentive schemes employed by the company, as well as the measures taken to address/ reduce those risks.

- **Non-executive director fees**

The report should include with regard to the remuneration of non-executive directors:
Information relating to the maximum aggregate non-executive director amount (NED fee pool), including:

- The total NED fee pool
- Changes to the NED fee pool in the past 5 years
- Total NED fees paid in the reporting period.

The NED fee pool is approved by shareholders. Shareholders should be able to easily access the history of these payments, without needing to read several years of remuneration reports. This information is easily aggregated in a table and would not add to the complexity or length of the remuneration report.

Remove:

Remove the accounting valuations of grants of equity made during the year (but not vested). This information should be made available within the financial statements.

Detailed descriptions of incentive plans which relate to grants made in previous years could be incorporated by reference to an easily accessed source, such the company website.

Enforce*:*

There is currently no enforcement procedures related to failure to comply with section 300A. CAMAC should consider whether civil penalties for failure to comply, or some lesser form of enforcement, such as audit and report by ASIC might assist in ensuring that the section is complied with.

Simplifying the incentive components of executive remuneration

The CAMAC information paper sets out the numerous guidelines of industry bodies in relation to executive remuneration, including the ASA policy *Executive Remuneration.* These guidelines provide broad boundaries with regard to incentive based remuneration. The ASA policy is probably the most prescriptive guideline.

Although care has been taken by the ASA to leave room for flexibility, few listed companies will comply with the policy in 2010, which is the first year it will be applied. The ASA acknowledges that the policy sets a higher standard than its previous policies with regard to executive remuneration, with the expectation that it may take several years before there is a significant level of compliance.

The ASA policy experience illustrates the difficulty in attempting to simplify the incentive components of executive remuneration arrangements by the use of regulation. In the view of the ASA it would be extremely difficult to do and would be likely to have unforeseen consequences.

The answer is not in regulating the contents of incentive plans, but rather in providing shareholders with the opportunity to send a clear message, which cannot be ignored, to the board that the structures are: not aligned with their interests, indecipherable or simply not working. The PC “two strikes” recommendation which has been accepted by the Government will allow shareholders the opportunity to protest in a way that boards will not be able to ignore.

APPENDIX A: ASA Policy – *Executive Remuneration*

Executive Remuneration

ASA Policy Statement: 23 March 2009

Background

Rates of increase in executive remuneration have accelerated over the past decade to such an extent that multi-million dollar packages have become commonplace in larger listed companies. The gaps between the pay of Australian CEOs and senior executives on the one hand, and other employees and the workforce in general on the other, have become huge and are the subject of increasing levels of valid criticism.

Retail shareholders have long been sceptical of the need for Australian CEOs to be remunerated with such increasing largesse. They have questioned the necessity, often claimed by boards, of having to meet international standards set by the two highest paying regimes of USA and UK. They view with suspicion the advice of "independent" remuneration consultants contracted by, and accountable to, those same boards. Retail shareholders have widely condemned the large termination payments granted to CEOs and others who have left their positions on retirement, resignation or sometimes following unsatisfactory performance. There is also increasing concern about high levels of short-term incentive payments and the potential for executives to focus on achieving short-term goals to the detriment of the longer-term interests of shareholders.

The structures of those components of remuneration packages which are classified as long-term and short-term incentive payments, often described as "at risk", have been challenged with some success and it is now the norm for payments to require preset performance hurdles to be met. Nevertheless, progress here has been modest and there remains a widespread view that incentive payments are too easily given for performance which is satisfactory only and by no means superior, and that these payments are neither earned nor well aligned with returns generated for shareholders.

Recent and current global financial turmoil and the accompanying massive diminution in shareholder wealth have reinforced the view that senior executive remuneration levels are excessive. Equally disturbing, in too many cases they have provided support to shareholders' conclusions that incentives embedded within remuneration structures are not well aligned with the interests of shareholders and encourage activities that conflict with long term wealth creation. The Australian Shareholders' Association (ASA) does not support statutory restrictions on remuneration levels and believes it is the responsibility of the boards of companies to deal with the problem. Nevertheless, ASA recognises an increasing risk of intervention by the Australian Government if the corporate sector fails to act. Consequently, ASA has prepared this updated policy paper for the guidance of listed companies. This updated policy position represents a hardening of ASA's position to one that is more reflective of the attitudes of retail shareholders towards remuneration issues.

The ASA Position

1. The structure and disclosure of executive remuneration should be concise, easily understood and transparent to investors.

2. The base salaries of senior executives need to be and in the great majority of listed companies probably already are, at sufficient levels to provide full and appropriate compensation where performance is adequate but not superior.

3. Incentive payments in addition to base salaries are acceptable where these reward superior, as against merely satisfactory, performance, which has been proven by the achievement of predetermined and challenging targets.

4. It is appropriate for the remuneration package of a CEO to include a substantial "at risk" element. As a broad indication only, intended as a guideline for any board which is planning the structures of its CEO's remuneration package, an incentive award equal to the amount of the base salary package is acceptable for a CEO who has achieved significantly superior performance. Payments which are significantly above this level, other than on an exceptional basis, are excessive and are unacceptable to retail shareholders.

5. Long-term incentive (LTI) arrangements based on preset performance hurdles and properly aligned with the interests of shareholders are the appropriate means for providing CEOs, and possibly other senior executives, with motivation and reward for demonstrated superior levels of performance. Recommended guidelines for achieving this alignment are set out below.

6. Short term incentives (STIs) are questionable as incentives for CEOs. They should be used only where the performance targets support and are entirely consistent with the company's long-term goals. STI arrangements may be appropriate for other senior executives, providing these awards are conditional upon achieving pre-set performance targets that are clearly disclosed to shareholders.

7. Boards must not permit executives to enter into arrangements (such as hedging) which reduce the risk elements essential to effective incentive schemes.

8. Termination payments to failed executives which are above statutory entitlements or that include additional amounts in lieu of notice are unacceptable to retail shareholders. Boards should consider this when negotiating departure conditions in employment contracts or subsequently.

9. Golden parachutes are totally unacceptable to shareholders. Other lump sum payments additional to the agreed annual remuneration package, for example, executive retention payments, and compensation for "benefits foregone at previous employers" are also in principle unacceptable to shareholders. Any exceptions need to be very clearly described and strongly justified as being in the company's best interests in the remuneration report.

10. Where there has been a significant, for example 20%, vote against a Remuneration Report by independent shareholders and the board concerned has failed to take appropriate corrective action, the ASA intends to vote undirected proxies against the re-election of any of the directors at the next AGM of that company.

Guidelines

Long-term Incentives

1. ASA views long term incentives as a means of (i) rewarding executives for creating shareholder value and (ii) providing incentives to create further value. There is no single test that adequately meets the requirements of both objectives. Consequently, LTIs should be based on two components, each subject to achieving company performance above a hurdle threshold, with all details clearly set out for shareholders at the time of adoption:
    a. One component should be clearly aligned with shareholders' interests and based on the achievement of total shareholder return (TSR) above the median for an appropriate comparator group. In this case vesting should commence at a modest level (no more than 10%) only when the company achieves a 51st percentile ranking and should increase progressively to reach full vesting no earlier than at the 75th percentile of the group.
    b. The second component should provide an incentive to achieve long-term improvement in company performance, typically the achievement of a hurdle that is based on a pre-set and superior level of increase in company earnings. This can be measured by, for example, growth in earnings per share, return on funds employed or another verifiable metric that the board considers best reflects long-term progress across the cycle.

2. LTI awards should be made in equity.

3. LTI performance should be assessed over a fixed period of no less than four consecutive years, with vesting at completion of the full assessment period.

4. The share prices used within the calculation of the TSR, i.e. those at the start and end dates of the vesting period, may be subject to short-term smoothing in order to avoid the unintended effects of price volatility, (for example, averaging over the three month period around the start and ending dates of the vesting period). However in such cases the formula used must be specified within the LTI scheme at the outset.

5. Should TSR be negative over the vesting assessment period there should be no award for that component, irrespective of relative performance against the comparator group.

6. There should be no retesting of performance against LTI hurdles. The need for retesting is eliminated if the vesting period is adequate and short-term smoothing is adopted.

7. In order to promote and support management succession and other strategic long-term objectives, CEOs' equity-based plans should provide that a meaningful portion of any equity

awards shall not be made available to the CEO for at least two years after vesting. This restriction should apply irrespective of whether the CEO remains in the position.

8. There should be no company loans associated with LTIs as this decouples any alignment with shareholders' interests that might otherwise have existed and is an inappropriate use of shareholders' funds.

Short-Term Incentives

1. Around 50% of STI awards should be based on verifiable financial performance metrics at the company level and/or of the area of responsibility of the individual executive.

2. The remainder of any award should be based on quantifiable performance indicators that are set at the start of the period.

3. In the interests of transparency, the performance indicators used to determine STI awards should be disclosed to shareholders. Disclosure may be retrospective if necessary to avoid disclosing commercially sensitive information.

4. Disclosure of STI amounts paid to senior executives should be supported by details of the maximum and minimum amounts available to be earned under the scheme.

5. A proportion of STI awards (ASA recommends at least 50%) should be in the form of equity. This equity must not be made available to the executive for at least two years after the end of the relevant performance period, irrespective of whether the executive remains in the position.

End Notes

[1] CAMAC, Executive Remuneration- Information Paper, July 2010, pp 23 - 25

[2] Section 300A (1) (BA) (iv) (B)

[3] Section 300A (1AA)

[4] Section 300A (1)(ba)