

13 August 2010

Corporation and Markets Advisory Committee  
Level 16  
Metcentre  
60 Margaret Street  
SYDNEY

Business  
Council of  
Australia

**By email:** john.kluver@camac.gov.au

Dear Sir/Madam



### **CAMAC inquiry into aspects of Executive Remuneration**

The BCA is pleased to make this submission to the Corporations and Markets Advisory Committee's (CAMAC) inquiry into simplification of reporting requirements and incentive components of executive remuneration.

The BCA acknowledges that there are issues of public discussion around the complexity of current executive remuneration disclosure but believe that it is important to ensure that any policy responses regarding executive remuneration pay proper regard to the central role that boards play in determining executive remuneration - including in setting appropriate incentives to align remuneration with meaningful measures of individual company performance appropriate to the particular circumstances of individual companies.

Any moves to dilute the authority of boards to determine appropriate remuneration structures – including incentive components - through overly prescriptive legislation is to be avoided.

As with other inquiries (such as the Productivity Commission's review of executive remuneration), CAMAC has an important role to play in ensuring that public debate and potential policy changes are based on a thorough understanding of the facts about contemporary public company practice in Australia, respect of the proper role and responsibility of directors and objective assessment of the potential costs and adverse implications of adopting specific regulatory responses.

The government has stated that it is seeking CAMAC's advice on how best to revise legislative architecture to facilitate simplification of reporting requirements on remuneration. In our view, CAMAC should consider a principles-based response to this issue. Given the inherent complexities associated with reporting modern, sophisticated incentive payment structures, it would be of significant concern if CAMAC was to recommend a 'prescriptive' legislative approach to deal with those issues.

Executive remuneration reporting and practices have evolved in Australia significantly in recent years and should be given time to evolve further. The BCA considers that effective, company-specific approaches need to be supported, not discouraged or constrained by new regulations. The aim should be to promote for a:

- reporting requirements that are principles-based, allow flexibility for boards to set remuneration arrangements to suit each company's circumstances, and provide clear and concise information for shareholders; and
- remuneration incentive packages that take into account the specific circumstances and objectives of individual companies.

### **Simplification of reporting requirements**

The government has asked CAMAC to:

- examine the existing reporting requirements contained in section 300A of the Corporation 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; and
- make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports.

Many executive remuneration reports have become complex for shareholders and the community to easily comprehend. Accordingly the BCA considers that there is scope for improving useful information for shareholders.

A range of proposals have been developed to improve the legislated reporting requirements of remuneration reports, and many of these were summarised in CAMAC's information paper. Various proposals have also been put forward by groups such as the Australian Shareholders' Association (ASA) and the Australian Institute of Company Directors (AICD). The complexity of the issues surrounding this debate, as well as the many views on improved reporting, highlight the difficulty associated with detailed prescription.

The aim of simplification should be to ensure that clear and concise information is provided on executives' current and prospective future pay. However, the variety of remuneration arrangements currently in place in Australia makes it difficult to prescribe requirements to achieve meaningful or standardised disclosure.

Against this background, the BCA concurs with the AICD's view that a principles-based approach to remuneration reporting should be adopted. Principles make clear the expectations for reporting, rather than the specifics. A principles-based approach also allows boards to determine appropriate and meaningful information that enables investors to make an informed assessment of remuneration practices.

There are a range of salient issues that need to be acknowledged in the area of remuneration reporting.

For example, the Productivity Commission in its final report on executive remuneration recommended that remuneration reports should include:

- a plain English summary of remuneration policies; and
- disclosure of actual remuneration received and total company shareholdings of individuals identified in the report.

The government supported this recommendation and requested CAMAC's advice on how best to revise legislation to reflect these reporting features.

The BCA supports the reporting of 'actual' remuneration received by executives. However, caution must be taken to ensure that legislative requirements for reporting retain the flexibility to report on the individual circumstances of an organisation and its executives. For example, 'actual remuneration' will often be delayed by a year following the remuneration report, because determination of bonuses and long term incentives may not be settled by the time the remuneration report is published.

Accordingly, it should be the role of companies to ensure that there is clarity around reporting of remuneration and the role of policy makers should be to ensure that legislation facilitates appropriate flexibility in this reporting. The BCA believes that the current legislative framework largely achieves this objective.

CAMAC should also be mindful that many apparently appealing proposals in this area can, on closer inspection, lead to more confusion and lengthy explanations. For example, the Productivity Commission recommended that the remuneration report include total company shareholdings of individuals in the report (Recommendation 8). Care must be taken to ensure that requirements to report aggregated shareholdings leads to useful information being disclosed. For example, the retirement of one executive who holds a significant parcel of shares will cause the reported aggregate shareholding to decline. Unless explained in detail, shareholders might be misled into thinking that the executive team, as a whole, was reducing its holdings in the company.

The Productivity Commission recommended that a 'plain English' summary of the remuneration report be prepared (Recommendation 8). The BCA supports the objective for reports to be drafted in 'plain English'. However, the BCA considers that it may be difficult to define 'plain English' appropriately in legislation or guidance. Such a requirement may effectively require companies to obtain legal advice to ensure that reports are drafted in 'plain English'.

Introducing the requirement that a summary of the remuneration report be prepared may not achieve the intended aims. In the BCA's view, the concept of a summary document could raise further questions about whether additional layers of reporting will actually achieve improved clarity for shareholders. Past experience has demonstrated that adding reporting requirements can instead merely increase the number of pages of reporting. For example, concise annual reports have proven to have had varying degrees of success, as they have been seen to add an additional layer of reporting burdens and costs and have not necessarily benefited shareholders.

Further questions remain, such as whether a summary document must have the same auditing requirements under the accounting standards as the bulk of the remuneration report. Even if auditing is not legally required, most companies may feel compelled to seek auditor sign-off to ensure consistency with the full remuneration report, thereby adding compliance effort and costs to annual remuneration reporting. The length and detail currently required in remuneration reports is very often driven by the requirements of auditors that full descriptions of employee reward schemes and their salient rules are contained in these reports,

even for relatively minor or legacy elements of the company's overall remuneration arrangements.

The CAMAC information paper summarises guidance and legislative reporting requirements from within and outside Australia. The BCA would be very concerned if legislative arrangements from for example, the United States, were to be recommended for Australia, given Australia's comparatively good performance in corporate governance. Australia has a good record of corporate governance, with a unique and well respected regime which incorporates legislation and an 'if not, why not' reporting approach through ASX Corporate Governance Council Guidelines. The Productivity Commission found in their final report on executive remuneration that *"while there had been rapid growth in executive pay (prior to the global financial crisis), the evidence does not indicate widespread failure in remuneration-setting across Australia's 2000 listed companies, nor significant adverse impacts on the performance of the corporate sector as a whole."*<sup>1</sup>

It would be erroneous for Australia to follow the path of great prescription, such as that outlined in the United States legislative reporting framework, and in particular the reporting of the CEO pay as a proportion of the median annual total compensation of all employees of the issuer. These types of requirements go beyond simplification of reporting requirements and instead raise consideration of issues such as quantum, salary caps and proportions of average earnings that have already been considered through the Productivity Commission inquiry. The Productivity Commission found that a *"key contributor to growth (and recent fall) in executive pay has been the strong shift to performance-based remuneration, especially (long-term) equity-based incentives. This change has been motivated by the need to align the interests and actions of CEOs and senior executives with the longer term interests of companies and their shareholders. This trend has been particularly marked for the largest companies."*<sup>2</sup>

Reporting of proportions of pay relative to average earnings may be meaningless unless it properly acknowledges the risk-based nature of significant elements of modern incentive pay. Again, under a properly designed, performance-linked remuneration structure, total pay (base pay and incentive/"at risk" pay) may vary significantly from year to year—up or down. These changes would inevitably require lengthy explanation if they are to avoid confusing both casual or professional readers alike. Proportional reporting may also deter performance-based pay and lead to de facto limits on executive remuneration. The Productivity Commission stated that *"prescriptive pay constraints (such as caps) are not called for, as they would be impractical, weaken the role of boards and have perverse economic consequences."*<sup>3</sup> It would therefore be very damaging to the economy to be revisiting issues that have already been dealt with by the Productivity Commission in this CAMAC inquiry.

The BCA considers that the usefulness of information relating to executive remuneration for shareholders will depend on the detail and definitions contained in the requirements.

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<sup>1</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p 357.

<sup>2</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p 358.

<sup>3</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p 357.

## Simplification of incentive components

The government has asked CAMAC 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; and
- make recommendations on how best to revise the legislative architecture to simplify the incentive components of executive remuneration arrangements.

The BCA does not believe that simplification of incentive pay structures is a matter that warrants any new regulation or legislation at present.

It is important to recognise that business must offer attractive incentives to secure and retain talented executives and future leaders. Increased forces of globalisation, including the prospects of pursuing employment opportunities overseas have been increasingly relevant factors for Australian executives especially within the professional services, resources and financial sectors. In this environment, Australian companies seeking to attract and retain skilled workers must be able to offer globally competitive conditions and remuneration packages – both in terms of structure and quantum – for all executives. This important consideration should, in the BCA's view, take precedence over any felt need to mandate simplification for pay arrangements.

The quantum of executive pay rather than its complexity appears to be at the heart of community concerns about remuneration. A critical issue for boards is, therefore, the need to align executive remuneration to meaningful measures of company performance that boards consider to be of most importance to the company's circumstances. These circumstances may change, sometimes significantly, from year to year.

As with any commercial negotiation, the amount and structure of remuneration will reflect a risk–return trade-off. Within this context and against the backdrop of the broader market considerations discussed above, a company board has to determine four key issues:

- The split between fixed and performance-based (or 'at risk') pay.
- Within performance-based pay, the split between long-term and short-term incentives.
- The nature of performance hurdles or benchmarks.
- The form of any reward (cash, shares, options).
- Entitlements associated with termination in various circumstances.

The key aspect of the debate is how to better link an executive's variable or 'at risk' remuneration with those factors that drive company performance over which executives have the ability to influence. This is not a simple exercise.

Inevitably a diversity and indeed complexity of measures and targets will be required within and across companies. This should not be surprising. Large companies are complex as are the vast majority of contracts that relate to their operation. This raises the vexed issue of how to ensure that there is clarity around performance incentives and hurdles and how to foster a broad understanding by shareholders of remuneration priorities, strategies and outcomes when many of the targets a board may set are commercially sensitive and would if made public provide information to competitors that may damage the company to the disadvantage of shareholders.

Non-professional shareholders often assume that pay should mirror company share price and that share price is the proper measure of management performance. This is often not the case, especially over short periods (under 2-3 years). Share price may be driven by investor sentiment to the company's sector or industry, or general economic conditions rather than the financial performance of the company in any given period. Moreover, many of the objectives set by boards may reflect long-term strategies that will not be reflected in financial performance in any given period.

It is generally understood that the goal of simplification of incentive arrangements is to drive more clearly aligned outcomes. However, there is a significant risk that legislative measures designed to simplify arrangements will result in more prescription and will cause companies and executives alike to instead view incentive arrangements as too difficult with the result that the highly desirable emphasis on performance-linked/"at risk" pay will be reduced.

For example, there are a range of equity-based instruments that may be used to align the interests of executives with shareholders, such as shares, options or share appreciation rights.<sup>4</sup> Recognising the range of the possible instruments, the Productivity Commission in its recent review of executive remuneration highlighted that:

*"..there is not a simple answer to the question of what the 'right' equity-based instrument is. A remuneration structure that works well at one company might prove disastrous at another. And what works well for an individual company at one point in time might not at another. Choosing the best equity-based instrument/s therefore requires careful consideration of the company's circumstances."*<sup>5</sup>

Performance hurdles are equally complex, with a range of methods of linking payments to specific performance benchmarks. Experience shows that efforts to use common and more widely understood metrics (such as total shareholder return or relative total shareholder return) do not always produce the desired results.

For example, as share prices have fallen, using measures such as relative total shareholder return as a performance benchmark may in fact reward volatility and market 'catch-up' rather than management out-performance. In contrast, in a rising market, relative total shareholder return is seen as being superior to total shareholder return, which simply rewards all for market momentum.

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<sup>4</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p 193.

<sup>5</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p. 198.

Similarly, it is also often difficult to prescribe appropriate proportions of the components of pay (such as fixed, short-term, long-term and bonuses). For example, while some have argued, on the basis of simplicity, for a return to a greater proportion of fixed pay, it is hard to see how this achieves a strong alignment with long-term shareholder interests.

Whilst the Productivity Commission recognised that simplicity around incentives could have advantages, they also noted that companies are different and that simplification of incentive arrangements is therefore a risk, stating:

*“prescribed’ or standardised pay structures might not be helpful in promoting improved performance (in much the same way that imposing standardised investment strategies across all companies would not be appropriate), yet could also be driving unnecessary complexity.”<sup>6</sup>*

The recent changes to the taxation arrangements for employee share schemes, provides an example of how greater prescription has acted to discourage businesses, both large and small, from using equity options.<sup>7</sup>

Share options have in the past been particularly important for start-up companies. Start-ups have traditionally used deferred payment alternatives as a mechanism to encourage investment and attraction of skilled executives where payment of cash salaries is not a viable option. There is evidence, however, that the new taxation arrangements may be discouraging the use of options, with risks to entrepreneurship and innovation.

Given the various complexities in determining superior performance, there is a strong case to be made for the continuing unfettered authority of boards to determine the details around equity-based incentives, including the size and quantum of at-risk payments.

There is already considerable guidance available to boards in considering the appropriate structure of incentive arrangements, including for example guidance provided by the Australian Prudential Regulation Authority (APRA).<sup>8</sup> However, APRA recognises the primary role of boards in establishing executive remuneration packages stating that *“APRA’s modus operandi is to let companies work out their own approach, within the ambit of APRA’s prudential standards, and for APRA then to challenge any company which is not, in APRA’s opinion, operating appropriately.”<sup>9</sup>*

It is with this in mind that the BCA would be deeply concerned if CAMAC were to recommend legislation to develop a ‘prescriptive’ regime to deal with incentive arrangements. Businesses and their commercial objectives differ and change over time and therefore incentive arrangements must be capable of flexibility to suit different circumstances. This important principle should override a desire for simplicity or standardisation of executive remuneration arrangements.

<sup>6</sup> Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne, p. 219

<sup>7</sup> Patrick Durkin, ‘Companies opt out of option rewards’, *The Australian Financial Review*, Monday 26 July 2010, p. 5

<sup>8</sup> Chapter 5, CAMAC information paper

<sup>9</sup> John Trowbridge, ‘Executive Remuneration The Regulatory Debate’, Executive Member APRA, 2009 Remuneration Forum, CGI Glass Lewis and Guerdon Associates, Sydney, 16 March 2009

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I trust that you find this submission useful.

If you have any questions or comments, please contact Ms Leanne Edwards, Assistant – Director, Regulatory Affairs on (03) 8664 2614 or [leanne.edwards@bca.com.au](mailto:leanne.edwards@bca.com.au).

Yours sincerely



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