Freehills

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By email

Submission on Executive Remuneration Information Paper

We have pleasure in submitting Freehills' Head Office Advisory Team's comments on CAMAC's Executive Remuneration Information Paper.

The Head Office Advisory Team (**HOAT**) supports the simplification of remuneration reporting requirements and supports legislative change that would facilitate simpler incentive arrangements and disclosures.

However, we would take care to distinguish between 'simpler laws' to facilitate incentive arrangements and 'simpler incentive arrangements'. We do not support direct regulation of the form, size or structure of incentives. We strongly believe that companies should retain the ability to reward and incentivise their personnel in the way that is most appropriate for their particular circumstances.

1 Identify areas where the Corporations Act and related regulations could be revised to reduce complexity, duplication and more effectively meet the needs of shareholders and companies

The current legislative framework results in undue complexity and duplication of remuneration disclosures and excessive compliance costs for companies (and ultimately their shareholders). We make the following comments and recommendations.

1. Ensure all remuneration reporting obligations are contained in the one piece of legislation. If all obligations are shifted to the Corporations Act, repeal the associated provisions in the Corporations Regulations and expressly state that AASB 124 does not apply to companies who report against the Corporations Act requirements.
2. If sections 300 and 300A of the Corporations Act are retained, ensure that the required disclosures regarding shares, options and rights correspond so that compliance with s 300A will automatically result in compliance with s 300.
3. Allow cross-referencing to earlier reports (other than when comparative information is expressly required). If a company has reported something in

respect of a prior financial year, it should not be required to report the exact same thing in a future financial year.

4. Limit disclosure 'requirements' to clear, measurable concepts.

5. Allow companies to make voluntary decisions regarding the level of disclosure they make on broader concepts such as 'policy'. Companies are likely to voluntarily elect to make such disclosures, as they need to 'explain' the hard reportable numbers to their stakeholders. Mandating disclosure of 'soft' concepts such as 'policy' tends to result in companies preparing boilerplate answers that provide little insight.

6. Do not create unnecessary overlap by using unnecessarily broad concepts or definitions.

7. A solution may be to redraft s 300A in a "checklist" format.

8. Limit mandatory disclosures (for listed companies) to the following items:
   - the "actual" value of remuneration that is paid or becomes "realisable" (i.e. vests) in each financial year (to be valued at the time the remuneration is paid or first becomes realised);
   - the conditions and vesting periods of any incentives granted during the year and the value of those incentives at the date of grant;
   - whether key management personnel are prohibited from hedging their incentives;
   - movement during the year in the number (but **not** the accounting value) of shares, rights and options held by each key management person under an employee incentive scheme;
   - a description of any change during the year to the conditions or vesting periods of any unvested incentives or any other change to the arrangements between the company and a key management person that would materially affect remuneration in a future period; and
   - termination entitlements.

2 Legislative changes to facilitate simpler incentive arrangements

1. *Ensure the tax legislation facilitates simple best practice arrangements*
   - The complexity of current remuneration arrangements is often driven by tax considerations. The need to structure an offer so that it qualifies for tax deferral can result in distorted structures for employee incentive schemes.
   - Having said that, taxation is critical to employee incentive schemes - equity can lose its attraction as an "incentive" if employees are taxed before vesting (and before the employee is able to sell a sufficient number of shares to cover any tax liability that arises in respect of them).
   - For this reason, cessation of employment should no longer be a "taxing point" for unvested shares granted under an employee share scheme. The current taxing point encourages early vesting on cessation of employment and discourages "best practice"

arrangements (recommended by APRA and the Productivity Commission) whereby unvested shares remain on foot after cessation and only lapse or vest if the original performance conditions are achieved in due course.

2 *Remove unnecessary regulatory "blockers" to straight-forward share-based compensation*

- New offers to the public of securities and other financial products are heavily regulated under the Corporations Act, and for good reason. In essence, those provisions were drafted to protect members of the public from using their own money to purchase stock in "unknown" third party companies who solicited their capital. The relationship between employees and their employer company is obviously quite different, particularly where the financial product being offered is a free "bonus".
- One of the factors complicating current incentive arrangements is the need to comply with the Corporations Act requirements that apply to new offers to the public of securities and other financial products. Freehills acknowledges that there are currently various exemptions provided for under the Corporations Act and in ASIC Class Order 03/184, which allow companies to issue securities under employee incentive schemes to both directors and employees. However, Freehills believes that these exemptions (and ASIC Class Order 03/184) are in need of 'revisiting', as they do not extend to a number of 'ordinary' equity incentive grants and create a number of anomalies.
- Amend the law so that (subject to an overriding requirement that no offer to an employee may be misleading or deceptive) employee incentive schemes are entirely exempted from the following aspects of the Corporations Act:
  - any requirement for a prospectus or other disclosure document to accompany the offer;
  - any requirement for the offeror to hold a financial services licence;
  - any of the managed investment scheme provisions that could arguably be applicable;
  - the hawking laws; and
  - for cash-settled share-based payments, the provisions applicable to derivatives.

  Such an exemption could be limited either by amount (grants to employees worth not more than $X) or size (grants which, in aggregate, do not exceed 5% of the company's issued share capital).

3 *Modify the termination benefits legislation*

- Some anomalies in the new termination benefits legislation have the potential to complicate remuneration arrangements.
- The unfortunate drafting in the new legislation has resulted in confusion over its intended application and unforseen consequences.

- The unintended impact of this legislation has been that corporations are seeking alternative ways to pay 'standard' benefits to departing employees because the new legislation prevents them from doing so. (It is not uncommon for senior executives to have contracts that allow them 12 months base salary, pro rata STI and pro rata LTI if they depart as a good leaver).
- The most obvious example of measures being taken is a move towards increasing base salaries and decreasing grants of equity incentives. This trend is directly contrary to modern concepts of 'good governance' which encourage senior executives having 'at risk' remuneration and 'skin in the game'.
- A particular problem with the new termination benefits legislation is that the new termination benefits cap is relevant for lower-level employees who serve as directors of subsidiaries (for instance, an overseas employee who sits on the board of a foreign incorporated operating subsidiary simply to satisfy a requirement to have at least one locally-resident director), and could unfairly impact "bonus" entitlements paid to long-serving lower-level employees when they retire from positions with only moderate incomes.
- There are other problems with the legislation that could distort remuneration arrangements, including:
  - the cap being calculated by reference to average annual base salary in the three years prior to termination – this means that any employee entitled to a standard 12 month severance payment will exceed the cap if they receive even a nominal salary increase in any of the three years before they cease employment; and
  - the cap being "pro rated" in the first year of service – employees who are terminated without fault in the first year of service have a logical claim to a significant severance payment given the disruption to their professional lives (often in circumstances where they have may have given up other employment to take up the position).
- One simple solution would be simply to increase the statutory cap from "12 months base pay, averaged over the past 3 years" to "12 months total remuneration, calculated at the date of departure". Another might be to expressly limit the application of the provisions to the key management personnel of listed companies.

If you have any queries, please contact Priscilla Bryans on 03 9288 1779 or Garth Riddell on 02 9322 4780.

Yours sincerely

Freehills Head Office Advisory Team
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