RiskMetrics (Australia) Pty Ltd
Level 4, 190 Queen Street
Melbourne VIC 3000
ABN: 88 081 368 327 AFSL Licence No. 297008

Attention: John Kluver
Executive Remuneration Inquiry
Corporations & Markets Advisory Committee
By email: john.kluver@camac.gov.au

13 August 2010

Thank you for the opportunity to comment on the Corporations & Markets Advisory Committee's (CAMAC) review of executive remuneration disclosure issues. ISS Governance Services, formerly RiskMetrics, is the world's largest governance advisory firm, providing governance research to institutional investors in Australia and around the world.

ISS notes that CAMAC has not put forward any discussion points or potential reform proposals of its own in relation to the disclosure of executive remuneration by Australian listed companies. The information paper released by CAMAC in July 2010 summarises approaches to remuneration disclosure in Australia and other comparable jurisdictions such as the UK and US and also notes reform proposals advanced by various parties in response to the Productivity Commission's inquiry into executive remuneration.

In the absence of specific items calling for a response, this submission has been structured to consider a number of the common complaints directed against remuneration reports apparent from submissions to the Productivity Commission and other public commentary. These responses have been written on the basis of our company's detailed review of more than 1300 remuneration reports at S&P/ASX 300 entities since the introduction of the remuneration report for reporting periods ending on or after 30 June 2005.

1. Remuneration report complexity

The Productivity Commission in its final report notes the views of participants in its inquiry that remuneration reports are overly long and complex.[1] The views of participants cited by the Commission as to report complexity and length were largely those of the management of listed companies.

From ISS' experience of reading remuneration reports prepared by large Australian companies report complexity is driven by company approaches to disclosure and remuneration rather than disclosure requirements, with the exception of share based payment disclosures (see below). Many remuneration schemes now adopted by Australian companies have considerable complexity in terms of the measures against which executive performance is assessed and describing these schemes in a simple fashion is difficult. Telstra Corporation, for example, in its 2007 remuneration report disclosed three different long term incentive schemes all applying for awards in the 2007 financial year: A scheme assessing performance for senior executives with six different performance hurdles overlaid with a 'gateway' hurdle assessed over two to four years;[2] a variation on this scheme applying to the CEO assessing performance over three one year periods[3] and a third plan for the COO paid in cash against unspecified targets.[4]

[1] Productivity Commission, *Executive Remuneration in Australia*, Inquiry Report No. 49, December 2009, p. 47.
[2] Telstra Corporation Limited, *Directors Report For the Year Ended 30 June 2007*, pp. 28-29.
[3] See n. 2, pp. 33-34.

ISS does not support mandating the structure of executive remuneration in Australia and it is clear from submissions to various reviews of executive pay legislation and practice in Australia that there is little support for firm rules on how companies should pay their executives. It is not clear in this environment how remuneration report length and complexity could be addressed without substantially *reducing* the information available to shareholders in these reports given most complexity of disclosure is a function of company remuneration practice.

Complexity is also often a function of a company's disclosure choices: Sonic Healthcare, for example, has since the introduction of the remuneration report disclosed the amortised value of equity incentives granted to its executive directors in a written paragraph below the table summarising cash remuneration.[5]

2. Information overload

Despite the length of remuneration reports, as noted by ISS and other respondents to the Productivity Commission inquiry, there is widespread non-compliance with the existing disclosure requirements. The length of reports is driven in part due to the complexity of company remuneration practice and also by the widespread use by many companies of boilerplate disclosure. It is apparent from reading hundreds of reports that many companies follow similar templates often with identical or near-identical wording. From discussions with listed companies and their advisors it appears these templates are provided by professional advisors such as law firms. This boilerplate discussion, often used for remuneration policy or how fixed pay levels are set, is of minimal use to shareholders and simply adds to the length of reports without providing information. Anecdotal evidence suggests however that over the past two years more listed companies are seeking to take 'ownership' of their remuneration disclosures and are discarding templates.

Remuneration consulting firm Guerdon Associates has estimated that less than 20 percent of ASX 300 listed companies comply with the Corporations Act requirement for listed companies to provide a "detailed summary" of the performance conditions attached to senior executive bonuses.[6] ISS, in its submission to the Commission, made a similar observation (see submission provided to CAMAC, pp. 12-13).[7]

Another area of frequent non-compliance is entitlements on termination under service contracts disclosed under s. 300A(1)(e)(vii) of the Corporations Act. ISS notes companies in disclosing termination payments made to senior executives routinely note that benefits were provided in accordance with contractual terms without these entitlements having been disclosed in prior remuneration reports. In a recent example, Downer EDI disclosed that its departing CEO Geoff Knox had received 243,013 unvested shares on departure as part of his employment contract.[8] Disclosures provided in the 2008 and 2009 remuneration reports on his termination entitlements were silent on any entitlement to unvested equity incentives.[9] More discussion of non-disclosure of termination entitlements is included in ISS' Productivity Commission submission (provided to CAMAC, pp. 11-12).

---

[4] See n. 2, p. 35.

[5] See, for example, Sonic Healthcare Limited, *Annual Report 2005*, p. 22 and Sonic Healthcare Limited, *Annual Report – 30 June 2009*, pp. 16-18.

[6] Guerdon Associates & CGI Glass Lewis, Submission to the Productivity Commission, 5 June 2009, p. 67. The requirement is contained in s. 300A(1)(ba) of the Act.

[7] ISS notes that the Australian Institute of Company Directors (AICD) in its reform proposal for remuneration reports has proposed making disclosure of performance conditions attaching to senior executive pay voluntary – see AICD, *Position Paper No. 15: Remuneration Reports*, June 2010, p. 21 . It is not clear why any such reform would be required given the widespread current non-compliance with s. 300A.

[8] Downer EDI Limited, 'ASX announcement: Grant Fenn appointed new managing director and chief executive officer', 2 August 2010, p. 7.

[9] Downer EDI Limited, *Annual Report 2009*, p. 28; Downer EDI Limited, *Annual Report 2008*, p. 16.

ISS acknowledges however that certain aspects of the formal disclosure regime provide minimal information to shareholders and should be abandoned or modified:

- **s. 300A(1)(c)(iii-iv):** This provision should, in line with the recommendation of the Productivity Commission, be amended to require only the disclosure of the remuneration of members of key management personnel of the group and remove the requirement for the disclosure of the remuneration of the five highest paid group and company executives.
- **s. 300A(1)(e)(iv):** This provision requires the value of options that lapsed during the reporting year held by key management personnel to be disclosed. ISS submits this requirement adds little value as the actual value of options that have not vested (as opposed to the fair value for accounting standard purposes) is zero. This section of the Act should be altered to require the number of options lapsed to be disclosed, and the grant date of the options that lapsed.
- **s. 300A(1)(e)(vi):** The provision requiring disclosure of the percentage of each disclosed executive's remuneration received as options should be removed. Shareholders concerned over the proportion of remuneration delivered as share-based payments will be able to make an assessment based on the information already disclosed.
- **s. 300A(1)(e)(vii):** This provision should be amended to require disclosure of the estimated cash payment and the value of equity incentives a disclosed executive would have received on termination, a change of control, retirement or resignation as at balance date. Companies would then also be free to disclose the contractual terms underpinning these payments on a voluntary basis. The provision should also require disclosure of the contractual basis of any termination payments made to departed executives during the reporting year.
- **s. 300A(1AA-AB):** The provisions requiring the remuneration report to incorporate a specific discussion of the company's performance during the financial year should be removed as they provide little value to shareholders. Section 300A(1)(b) – which requires a discussion of the relationship between remuneration policy and performance - provides adequate statutory guidance without additional proscriptive requirements.
- **Corporations Regulations 2M.3.03(1)(12)(h):** The requirement to disclose the estimated "maximum and minimum possible total value of the bonus or grant (other than option grants)" for future financial years should be removed. The other requirements under item 12 of this section and under the Act itself which require disclosure of unvested outstanding equity incentives as at balance date provide sufficient information to shareholders to determine the potential rewards executives may receive in future years.

3. Share based payment disclosures

Much of the commentary on the problems of remuneration disclosure, including through submissions to the Productivity Commission inquiry, has focused on the disclosed value of share-based payments, especially the amortised value disclosed in the summary remuneration table used to disclose executive pay by nearly all listed companies.[10] It is notable that this criticism has arisen since the onset of the credit crisis at the beginning of 2008 and has grown during a period in which the disclosed fair value of equity incentives has routinely overstated the value received by executives. There was minimal criticism of the current share based

[10] The inclusion of share based payments values in this table is not mandatory but is industry practice. See n.5 for an example of a company that discloses the value of remuneration from share based payments outside of the table; similar approaches were adopted by Qantas in 2008 and Fairfax Media in 2009.

payments disclosure requirements prior to the sharp downturn in equity markets at the commencement of the credit crisis. This may have been because disclosure regimes based around the grant date fair value of equity incentives amortised over the vesting period often significantly understated executive pay during bull markets because the fair value estimates of equity incentives granted are typically significantly lower than the realised vested value of such incentives during periods of high share prices.[11] Even during bear markets the disclosed fair value of equity incentives is often substantially lower than the derived value: As an example, in the 12 months to 30 June 2009, 1 million options with a fair value of $4.315 million were exercised by Sonic Healthcare's CEO with a realised value of $6.44 million.[12]

It is however clear that the estimated fair value of equity incentives granted to senior executives and disclosed in remuneration reports invariably is either much higher or much lower than the actual value received by the executive. This is in part a function of the difficulties in valuing equity based incentives, a difficulty also confronting the many boards that determine the number of equity incentives to be granted to a senior executive based on a dollar value divided by an estimated fair value for a single equity incentive.[13] ISS is unaware of any objections from the issuer community concerning the use of fair values to determine the size of equity grants, a process which invariably leads to larger numbers of equity instruments being granted than if grant sizes were based simply on share prices at the time of grant.

ISS does not consider that remuneration valuation and disclosure requirements should be driven by short term considerations from issuers concerned at 'over-reporting' of remuneration when such concern has been absent during periods when remuneration disclosures have consistently under-reported actual pay. Remuneration disclosures and financial reports generally should also not be driven by the 'lowest common denominator'. There is no obstacle to listed companies providing so-called 'shareholder friendly' concise reports, including simplified remuneration disclosures, in addition to statutory reporting. There is also no obstacle to listed companies providing both realised (ie. cash pay and the value of equity incentives actually vested) and statutory remuneration disclosures, as many have done over the past two years (usually in cases where realised remuneration is lower than statutory remuneration). This practice is akin to the well-accepted use of underlying or pro forma earnings by companies in reporting to investors in addition to statutory profit and as with the use of underlying earnings measures, investors over time will be able to derive information from how companies' preferred measure of remuneration changes over time.

Valuations of share based payments to executives entail costs for shareholders and for this reason are expensed in financial statements. There does not appear any reason, as suggested by some parties, to not disclose the specific costs determined under AASB 2 as they relate to individual senior executive's pay.[14]

There are however several aspects of the current valuation and disclosure regime for share based payments under Australian International Financial Reporting Standards that could be improved. Two shortcomings with the existing requirements are as follows:

- At present, AASB 2 requires companies to value share based payments differently depending on the type of hurdle applying to the equity instruments and whether the instrument is settled using cash or equity. There does not appear any convincing

[11] See research paper provided to CAMAC: ISS, *CEO Pay – It's even higher than you think: Valuation of executive options in Australia*, September 2006.
[12] See n. 5, 2005 report, p. 26; 2009 report, pp. 19, 98.
[13] See, for example, Macquarie Group, *Notice of Annual General Meeting*, 15 June 2010, p. 16.
[14] See n. 7.

rationale for these differential valuation requirements, especially differentiation based on the type of performance hurdle used.[15]

- Companies are also not required to disclose the extent of any discount they apply to equity incentives to take account of the probability of vesting, while other assumptions used in assessing fair value are disclosed. There does not appear to be any compelling reason why the discount applied in determining the fair value should not be disclosed to shareholders, especially if fair values are used to determine the number of equity incentives granted to executives.

In summary, ISS does not consider there is a need for major changes to the remuneration disclosure regime in Australia. Companies remain free to provide supplementary non-statutory disclosure on remuneration to shareholders, as is the case with financial information, in the interests of providing what they consider to be 'better' disclosure.

There is room for relatively minor modifications to existing law but changes designed to substantially simplify remuneration disclosures are unlikely to be successful unless they materially reduce the quality and quantity of information disclosed to investors. This is unlikely to improve the ability of investors to determine whether remuneration policies and outcomes are aligned with their interests.

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the issues raised in your Issues Paper.

Yours sincerely

Martin Lawrence
ISS Governance Services
03 9642 2062
martin.lawrence@issgovernance.com

[15] Australian Accounting Standards Board, *AASB 2: Share-based Payment*, 19 October 2009. See paragraphs 19 to 21 for treatment of performance hurdles and paragraph 30 for valuation of equity incentive grants settled with cash.