Law Council
OF AUSTRALIA

16 August 2010

Mr John Kluver
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

By email to john.kluver@camac.gov.au

Dear Mr Kluver,

Submission in relation to the Executive Remuneration Information Paper

I have pleasure in forwarding the following comments on the Information Paper which have been prepared by the Corporations Committee of the Business Law Section of the Law Council of Australia (**Committee**). These comments have been endorsed by the Business Law Section. Owing to time constraints, the comments have not been considered by the Directors of the Law Council of Australia Limited.

General

The Committee supports the simplification of remuneration reporting requirements as outlined below. The Committee supports legislative change that would facilitate simpler incentive arrangements and disclosures, but does not support direct regulation of the form, size or structure of incentives.

The legislative framework for remuneration disclosures

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

The Committee suggests that the mandatory disclosures to be included in a listed company's remuneration report should be limited to disclosure of the following items in relation to each key management person:

- 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;

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- 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.

If, as foreshadowed, the government introduces laws prohibiting the hedging of unvested incentives or vested incentives that remain subject to trading restrictions, no separate disclosure in relation to a company's hedging policy would be required.

The Committee submits that the disclosures listed above will provide shareholders with a true and fair view of the remuneration arrangements of the key management personnel of a listed company, and as such these disclosures should be mandated by law. Companies would of course be free to voluntarily disclose any additional information they felt was relevant to a shareholders' consideration of the information contained in the mandatory disclosures, such as a plain English summary, a description of the company's remuneration policy, or discussion of the link between remuneration and performance. The Committee does not support making these or any other additional disclosures mandatory.

For consistency of reporting obligations, any changes to s 300A of the Corporations Act must be accompanied by complementary amendments to the Corporations Regulations and the Accounting Standards.

In the alternative, if the AASB takes the view that the Accounting Standard disclosures should not be amended to complement the revised provisions in the Corporations Act and Corporations Regulations, the Corporations Act should make it clear that any additional accounting standard disclosures may appear in the accounts, but need not appear in the remuneration report.

Legislative changes to facilitate simpler incentive arrangements

As stated above, we do not support direct regulation of the form, size or structure of incentives. In the Committee's opinion, it is critical that companies retain the ability to reward and incentivise their personnel in the way that is most appropriate for their particular circumstances. One size does **not** fit all.

However, there are other legislative provisions that constrain the effective setting on incentive arrangements, as discussed below.

Ensure the tax legislation facilitates simple best practice arrangements

The complexity of current remuneration arrangements is often driven by tax considerations. For instance, a number of "structural" conditions must be met before shares granted under an employee incentive scheme can qualify for tax deferral. This distorts the structure of employee incentive schemes because equity can lose its attraction as an "incentive" if employees are taxed on them before they vest (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 the same 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.

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. The Committee 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, the Committee 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.

The following example illustrates the point. An equity incentive grant to employees of a de-merged listed entity cannot rely on the scheme booklet as an exemption to the prospectus disclosure requirement (if the de-merger takes place through a scheme of arrangement) and the exemptions in ASIC Class Order 03/184 cannot be relied on because the new entity will not have been listed for 12 months.

Modify the termination benefits legislation

Some anomalies in the new termination benefits legislation have the potential to complicate remuneration arrangements.

The Committee has previously made a submission on this legislation, and reiterates its concerns. 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 be offered 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 its intended application is unclear and currently a number of differing views exist as to how it should be interpreted. The Committee submits that legislation (particularly legislation that could result in a strict liability offence for both companies and individuals) should be clear on its face.

For example, on one interpretation of the legislation, the new termination benefits cap applies to 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;
- the cap being calculated by reference to average annual base salary in the three years prior to termination discriminates against employees who have, in the 3 years before ceasing employment, taken maternity or other unpaid leave; 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".

Additional matters affecting Executive remuneration

Do not introduce the "two strikes" rule

Many of today's complex remuneration arrangements are driven by the desire of some companies to comply with perceived "best practice" structures. This can result, for instance, in incentives with complex or multiple performance conditions, deferral arrangements and "unusual" post-vesting disposal restrictions. While these measures typically result in a closer alignment between executive and shareholder interests, they can often be confusing or misunderstood by shareholders (particularly when many different "best practice" features are combined in one incentive).

Introducing a "two strikes" rule will result in greater pressure for companies to comply with "best practice" structures recommended or expected by proxy advisers and other corporate governance bodies, regardless of whether these structures are the "best fit" for the company or are appropriate given their business and operating environment.

In essence – the real concern is that the "two strikes" rule will effectively shift the responsibility for decision making in relation to staff rewards and incentives from the company (through its board and management) to shareholders. This contradicts the fundamental principles of how corporations operate.

If you have any queries, in the first instance please contact the Committee Chairman, Mr Guy Alexander, on 02 9230 4000.

Yours sincerely

W Grant

Bill Grant
Secretary General