
1 What is the inquiry about?

Key points

- Many in the community have for some time been concerned about the level and growth of executive pay, particularly relative to average wages. More recently, such concerns have been amplified by several factors, including:
 - the attribution of the global financial crisis to unrestrained corporate greed in the financial sector
 - declining shareholder wealth and rising unemployment in Australia, juxtaposed with conspicuously large executive pay and ‘golden parachute’ outcomes
 - the decision by Pacific Brands — a company in receipt of taxpayer funds — to move its manufacturing operations offshore after appointing a new CEO.
- Some participants argued that egregious executive pay outcomes are evidence of systemic failure; others contended that current arrangements generally work well and that inappropriate pay practices are the exception.
 - Nevertheless, if community concern about executive remuneration were reflected in a lack of trust in corporate governance, there may be ramifications for the corporate sector generally and the wider economy.
 - Similarly, poorly designed remuneration arrangements that lead to inappropriate risk taking and short-term behaviour, particularly in the finance sector, can also have wider economic impacts.
- In line with the Commission’s terms of reference, and reflecting its economy-wide perspective, this report:
 - seeks to establish the facts about what has happened to executive remuneration (to the extent that data limitations permit), and the significance of different drivers
 - assesses the effectiveness of the existing regulatory and governance framework
 - makes recommendations designed to promote better alignment between the interests of companies and shareholders, and to achieve improved outcomes for the community.

1.1 Background to the inquiry

How much executives are paid has long been a matter of considerable community interest.

The Business Council of Australia (BCA) remarked in 2004:

Rarely a week goes by without some commentary on CEO pay. Debate inevitably focuses on excessive amounts and comparisons with the pay of average wage and salary earners. (2004a, p. 1)

The BCA's public opinion polling has found that most respondents believed that executives were overpaid. It has also revealed limited understanding about the drivers of executive pay and the concept of wealth creation (BCA 2004a).

A range of groups, including unions, social researchers and media commentators, have for some time expressed concern that the level and growth of executive pay is out of step with average wages, widening the gap between executives and other employees. In buoyant economic times, the extent to which this is an issue for the community tends to wax and wane, but concern can be galvanised quickly by events such as a corporate failure, the high profile appointment of a chief executive officer (CEO) from overseas and most recently, by the immediate aftermath of the global financial crisis.

Although the financial crisis can be traced to multiple origins (see for example, the FSA 2009b, Gruen 2009, and the IMF 2009, as well as box 1.5), of relevance for this inquiry is a view that executive pay practices encouraged excessive risk-taking in the financial sector. In announcing the inquiry, Ministers stated that 'unrestrained greed in the financial sector has led to the biggest global recession since World War II' (Swan and Sherry 2009a, p. 1).

As the financial crisis struck national economies, scrutiny of corporate performance increased. While company values and shareholder returns were falling, executive pay seemed to be unaffected. In the United States and Europe, it was widely publicised that as taxpayers were called on to bail out ailing companies, executives were receiving bonuses and generous termination packages — instances attracting worldwide attention included the US insurance company AIG and, in the United Kingdom, the Royal Bank of Scotland.

In the public eye, these outcomes have come together in a narrative about:

- executive greed and mismanagement, especially of risk, causing the financial crisis
- taxpayers subject to an erosion of their living standards seeing public funds diverted to bail out failed companies
- executives placing their remuneration above shareholder and company employee interests (including some exiting with large termination packages).

Unlike other economies, however, Australia’s prudential regulatory framework has stood up well. Many contend that the ‘stress-testing’ of that framework has shown it to be world’s best practice — there have been no collapses of major banking institutions or iconic manufacturers.

Nevertheless, there have been several widely publicised and seemingly egregious pay and termination outcomes locally, which have triggered a strong reaction from many in the community. Many Australians are shareholders — either in their own right or indirectly through superannuation contributions — and negative returns on these investments do not sit well with perceptions about burgeoning executive pay. Added to this volatile mix was the decision by Pacific Brands, a domestic company in receipt of taxpayer support, to relocate its manufacturing operations offshore. The circumstances surrounding this decision triggered a considerable community backlash and a sharp political response, culminating in this inquiry (box 1.1).

The depth of community concern was reflected in the joint Ministers’ press conference announcing this inquiry, where expressions such as ‘greed’ and ‘obscene’ were used. The Government declared that it was ‘determined to ensure regulation of executive pay keeps pace with community expectations’ (Swan and Sherry 2009a). Reinforcing this point, it simultaneously announced that it would reduce the shareholder voting threshold for any termination payments from seven years total remuneration to one year’s base pay.

Some participants have argued that executive pay outcomes demonstrate systemic failure and a need for strong regulatory measures, such as caps or restrictions on tax deductibility. Others have argued that current arrangements — in which boards have the responsibility to set pay within corporate governance and reporting frameworks — on the whole work well.

Even those who contend that the current arrangements are working well often see scope for improvement, and some have pointed to instances of poor remuneration practice — typically termination payments that appear unrelated to performance (box 1.2). The fact that the same examples are generally cited from both perspectives (for example, Toll, Oxiana, Transurban, AGL Energy, and Babcock and Brown) raises questions about whether these are symptomatic of more pervasive failures or represent exceptions or outliers. The Australian Human Resources Institute stated that:

... the last 10 or 15 years has seen enormous pay [growth] in top executive pay, and not unrelated to growth in the size, the market capitalisation of large companies, and globalisation. But there have been excesses, nobody can deny that ... a number of things we’ve seen happen would stretch any reasonable standard of the community acceptance ... But we do remark that most of those excesses occurred offshore. There have been some in Australia but relatively few. (trans., pp. 129–30)

Even if such outcomes are not the norm, they may have shaped the community's view of corporate decision-making arrangements and practices more broadly.

Box 1.1 Pacific Brands triggers public 'outrage'

In late February 2009, Pacific Brands announced that it would relocate its manufacturing operations offshore, resulting in the loss of around 1800 jobs. It was widely reported that the decision coincided with sharp increases in remuneration for the company's executives. The Government reacted quickly, with the Treasurer noting:

... the workers are right to be absolutely furious with their management, and certainly their management has got a lot of explaining to do. ... to see that a privileged few are doing so well at a time when thousands of workers are being retrenched is frankly sickening. (Swan, W. 2009, p. 1)

Within a week, Pacific Brands' receipt of taxpayer support under textiles, clothing and footwear assistance arrangements was under scrutiny. The Prime Minister noted:

... what Pacific Brands has done is ... in so many respects, beyond the pale. In terms of the monies that they've got from the Government, we'll go through all of that in terms of what can be extracted back from them. (Rudd 2009, p. 6)

When this inquiry was announced at a joint Ministers' press conference on 18 March, the Treasurer referred to:

... significant community concern about excessive pay practices, particularly at a time when many Australian families are being hit by the global recession. (Swan and Sherry 2009a, p. 1)

The Minister for Superannuation and Corporate Governance cited Pacific Brands:

... it's been brought to our attention that the CEO of Pacific Brands left the company with a golden handshake of \$3.4 million. (Swan and Sherry 2009b, p. 2)

As RiskMetrics noted, community outrage can be very influential:

... the effectiveness of the outrage constraints are probably sharper now. Look no further than Pacific Brands ... that sent a signal to a lot of boards that your brand may actually be at risk where you are mismanaging ... perceptions around executive pay. (trans., p. 363)

RiskMetrics also observed that the newly appointed CEO was 'treated unfairly' (trans., p. 363) as her reported pay increase actually reflected a promotion from a divisional general manager to CEO — at less pay than the outgoing CEO.

Pacific Brands' 2009 annual report estimates a total remuneration package of around \$1.07m for the CEO in the 2009 financial year, down from the corresponding 2008 value of around \$1.86m (Pacific Brands 2009).

In the most recent reporting season, Qantas' payout to former CEO Geoff Dixon attracted a significant amount of media attention (ABC 2009b, Creedy 2009). Dixon's total reported remuneration in 2008-09 was almost \$11 million, part of which comprised a contentious superannuation payment that related to changes in superannuation tax laws. Qantas' remuneration report subsequently attracted a

significant ‘no’ vote in the latest reporting season, as did some other companies, such as Downer EDI and Transurban. (See chapter nine for further detail on companies that recorded significant votes against their remuneration reports in the 2009 reporting season.)

Box 1.2 Questionable remuneration outcomes

The Government responded to community concerns about contentious termination payments by lowering the threshold at which such payments must be approved by shareholders. In announcing the reform, the Minister for Superannuation and Corporate Law singled out two cases:

In 2008, Owen Hegarty of Oz Minerals received a bonus of \$8.35 million, which was 642 per cent of his base salary. ... Consolidated Media, John Alexander in 2008 received [a] \$15 million golden parachute, 468 per cent of his salary. (Swan and Sherry 2009b, p. 3)

Various participants identified other instances of large termination payments. In its submission to this inquiry, Regnan provided the following case studies:

Oxiana

‘... Owen Hegarty engineered a merger of Oxiana with Zinifex which was very unpopular with shareholders and widely commented on as destroying shareholder value. Upon his retirement the Oxiana board proposed a \$10.6 million termination payment to shareholders under obligation from legislation (due to the size of the payout), which shareholders rejected.

Later, the board of the new company, Oz Minerals, elected to award Owen Hegarty a slightly smaller termination payment of \$8.35 million which was not large enough to trigger a shareholder vote ... Oxiana's share price has since fallen from \$2.63 at Owen Hegarty's retirement on 20th June 2008, to \$0.60 as at 12th March 2009'. (sub. 72, p. 18)

Transurban

‘As the outgoing Chief Executive of Transurban Group retiring on 4th April 2008, Kim Edwards received \$16 million remuneration in his final year including a \$5.2 million termination payment. Two months later under a new Chief Executive, the company announced that the previous shareholder distributions of 58c were ‘substantially in excess of operating cash flow per security’. A capital raising, a halving of future distributions and a cost reduction program were subsequently announced. The stock price now sits at \$3.91 as at 12th March 2009, relative to \$6.60 on Kim Edwards' day of retirement'. (sub. 72, p. 16)

AGL Energy

‘Paul Anthony experienced very high levels of remuneration during an 18 month tenure at AGL Energy preceding and following its listing on 12th October 2006. As part of sign-on, Paul Anthony received \$1.64 million cash and approximately \$4.7 million of AGL Energy shares held in escrow for two years. In addition, he received a \$1.56 million cash bonus during his first year of tenure. However on the 15th October 2007 AGL Energy issued a substantial profit downgrade, followed shortly by Paul Anthony's resignation on 22nd October 2007. Over the space of ten days from the profit downgrade to Paul Anthony's resignation, AGL Energy shares lost 17.4% of their value. Almost 12 months after Paul Anthony's resignation, shareholders learned via the FY08 Annual Report released in September 2008 that a termination payment of \$5.1 million had been paid'. (sub. 72, p. 21)

1.2 The Commission's task

The Commission has been asked to report on the framework and structures around the remuneration of directors and executives in companies that are disclosing entities regulated under the *Corporations Act 2001* (Cwlth). The terms of reference ask it to consider:

- trends in remuneration in Australia and internationally, including the relationship between types of remuneration and corporate performance
- the effectiveness of the framework for remuneration practices, including disclosure and reporting, and the role of boards, executives, shareholders and other stakeholders
- the role of large local institutional shareholders (such as superannuation funds)
- mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community
- the effectiveness and applicability to Australia of the international responses to remuneration issues arising from the global financial crisis.

The Commission was asked to make recommendations on how the existing 'framework' governing remuneration practices in Australia could be strengthened.

The Commission was required to liaise with the Review of Australia's Future Tax System and the Australian Prudential Regulation Authority (APRA) in relation to extensions to governance within APRA-regulated institutions. (The full terms of reference are reproduced at the front of this report.)

Scope of the inquiry

This inquiry focuses on an examination of executive pay practices for companies that are disclosing entities under the Corporations Act (box 1.3) — in essence Australia's 2000 or so publicly-listed companies. Outside the scope of the inquiry, therefore, are non-listed companies (including foreign multinational corporations and privately owned companies¹) and the professions (such as legal and accounting firms). Some key terms and definitions are outlined in box 1.4.

¹ A survey of private companies (220 responses) found the proportion of respondents with annual turnover of less than \$20 million was around 37 per cent. Around 29 per cent had turnover of over \$100 million, including 7.5 per cent with turnover greater than \$400 million (KPMG 2009a).

Box 1.3 Disclosing entities

Under the Corporations Act, unless specifically exempted, a body is a ‘disclosing entity’ if it has enhanced disclosure securities. Enhanced disclosure securities encompass arrangements where:

- securities have been issued following the release of some form of product disclosure document (typically a prospectus)
- securities have been issued and 100 or more persons hold the securities.

Consequently, disclosing entities generally:

- include listed companies and managed investment schemes (trusts)
- include unlisted companies that have issued debentures (a class of fixed interest security)
- exclude private companies, foreign multinational corporations, sole traders and partnerships.

The framework for the regulation of executive remuneration and corporate governance as a whole is built around a mix of ‘black letter’ law, ‘soft’ law and guidelines:

- ‘Black letter’ law includes the Corporations Act and Australian Securities Exchange (ASX) listing rules that provide sanctions for non-compliance.
- The ASX Corporate Governance Council’s principles and recommendations provide an industry-wide framework of corporate governance ‘soft’ law for listed companies and their investors. Compliance is not mandatory, but disclosure about whether the recommendations have been complied with is required. Where a company has chosen not to comply it is obliged to explain — the ‘comply or explain’, or ‘if not, why not’ rule.
- Non-regulatory guidelines are issued by a range of organisations, including the Australian Council of Super Investors, the Australian Institute of Company Directors and the Australian Shareholders’ Association.

The regulatory framework is described in detail in chapter 5.

Box 1.4 Companies: key terms and definitions

The entities ...

A *listed company* can offer shares for sale to the public and the liability of shareholders for the company's debts is limited (chapter 2).

the people ...

Shareholders buy a stake in a company with a right to share in profits through dividends (and may secure a capital gain if share values increase).

Executives are not defined in the Corporations Act, but can be taken to include senior management (for example, CEOs, managing directors and company secretaries).

Key management personnel are defined, in accordance with accounting standards, as 'persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity'.

Directors supervise company management collectively as a *board* and have a fiduciary duty to act in the interests of the company. The board appoints the CEO and other senior executives.

Executive directors — as opposed to *non-executive directors* — are company employees (typically a senior executive) as well as being board members.

their pay structures ...

Executive remuneration may be made up of the following:

- *Base pay/salary*: usually cash remuneration, including superannuation.
- *Short-term incentives*: typically annual cash bonuses linked to performance hurdles.
- *Long-term incentives*: such as shares/stock options linked to performance hurdles.
- *Non-recourse loans*: typically take the form of interest-free loans for executives to purchase shares in the company. The company has a claim to the shares purchased, but the executive is not required to discharge the loan.
- *Termination payments*: (or 'golden parachutes') made when employment ceases.

Non-executive director remuneration typically involves a simple fee structure drawn from a 'fee pool' which is subject to shareholder approval. The ASX Corporate Governance Council guidelines state that directors should not receive options, bonus payments, or retirement benefits (other than superannuation).

and their pay disclosure.

The *remuneration report*, as required under the Corporations Act, discloses information about a company's key management personnel and the five most highly remunerated group and company executives (if different).

APRA review of executive remuneration and risk taking

APRA has been developing a framework for executive remuneration for authorised deposit-taking institutions and general and life insurance institutions. It released a consultation package in late May, followed by an additional consultation package in September, and released its final prudential requirements for remuneration on 30 November 2009.

APRA has proposed a number of modifications to governance standards to reflect the principles of ‘sound compensation practices’ for significant financial institutions outlined by the Financial Stability Forum in April 2009 (FSF 2009). The Financial Stability Forum’s recommendations on remuneration practices aim to curtail incentives for excessive risk-taking. They include requirements that: compensation be adjusted for all types of risk; institutions disclose clear, comprehensive and timely information about their compensation practices; and directors engaged in financial and risk control be independent.

APRA’s focus is on the structure, rather than quantum, of executive pay. It views boards of directors as ultimately responsible for remuneration matters. However, it proposes extensions to governance standards to require boards to establish a remuneration committee and establish, maintain, and periodically review a written remuneration policy.

APRA (2009d) has stated that its final standards will come into effect on 1 April 2010. By this date, APRA-regulated institutions will be required to have a board remuneration committee in place, as well as a remuneration policy.

An issue for this inquiry, therefore, is the potential applicability of APRA’s framework — in part or in whole — beyond authorised deposit-taking institutions and the insurance sector.

Review of Australia’s Taxation System

The terms of reference for the review, chaired by Treasury Secretary Ken Henry, require it to consider issues such as:

- the appropriate balance between taxing the returns from work, investment and savings, consumption (with the exception of the GST), and the role played by environmental taxes
- improvements to the tax and transfer system for individuals and families
- enhancing the taxation of savings, assets and investment, including company taxation

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- simplifying the tax system (Treasury 2009a).

The review has issued a number of discussion papers, with its final report due in December 2009.

Taxation arrangements for executive remuneration fall within the scope of the Henry Review, but may not be a broad area of focus. In contrast, how tax arrangements influence the composition and structure of executive remuneration and interact with measures to align executive and shareholder interests is an important element of the Commission's inquiry (and also APRA's review). Whether recent changes to the tax treatment of share and option schemes, for example, militate against the use of long-term vesting for equity-based payments is one such taxation issue (see chapter 10).

On 21 October 2009, the Government introduced legislation into Parliament to reform taxation arrangements for employee share schemes retrospectively from 1 July 2009. As part of these changes, the Board of Taxation is undertaking work on the valuation of employee share scheme options and taxation arrangements for employee share scheme equity provided by start-up, research and development, and speculative companies. It is due to report by February 2010 (Board of Taxation 2009).

1.3 The Commission's approach

The Commission's approach to examining arrangements for the remuneration of directors and executives is ultimately directed at improving outcomes for the community. The Commission's enabling legislation directs it to 'have regard to the need to improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community' (*Productivity Commission Act 1998* (Cwlth), s. 8(1)(a)). This is consistent with an emphasis in the terms of reference on securing better outcomes for shareholders and the wider community.

The key stages of the Commission's approach have been to:

1. identify (policy-relevant) problems and why individuals and markets may fail to adequately promote community wellbeing of their own accord
2. evaluate the performance of existing institutional and regulatory arrangements, which are, in part, directed at such problems
3. investigate modifications or alternatives that could address deficiencies
4. recommend options that are likely to yield the greatest net benefits.

Understanding the nature and extent of the problem requires an examination of executive pay setting practices and outcomes in theory and in practice. For example, can observed remuneration outcomes be explained by the characteristics of the market for executives? What are those characteristics? Which factors are more influential? How far short does observed behaviour fall from what may be realistically obtainable? What impact have remuneration outcomes had on company performance, economic efficiency and, ultimately, community living standards?

A basic challenge confronting such analysis is a dearth of consistent, long-running data. For one thing, there are no time series data of sufficient duration to be able to examine the change in remuneration outcomes across business cycles. The most detailed data the Commission has been able to access covers the six year period 2003-04 to 2008-09. Earlier data are not consistent. Moreover, data on total remuneration contains a mixture of base salary ('cash in hand') and estimates of incentive-based remuneration (shares and options) which may not be realised. The extent to which the accounting estimates are realised will vary with the business cycle itself. This not only makes it difficult to estimate trends in remuneration, but also what is driving those trends, and links to performance.

Given these difficulties, the Commission has made use of data from a variety of domestic sources, as well as research from the United States and other countries where appropriate, together with qualitative information, much of which has come from inquiry participants and experts in the field. It has sought to shine light on the issues in a variety of ways to test the soundness of different hypotheses. Ultimately, with all the uncertainty, considerable judgment is called for, particularly in relation to the magnitude of identified problems and the relative downside risks in intervening versus doing nothing.

In a highly interdependent market, there is also a risk that policy actions in one part of it will react adversely with actions elsewhere. It is important, therefore, to take a 'holistic' approach, in which the various elements of the system can be considered as a whole, to produce a package of actions that has coherence.

Pay quantum versus structure

The quantum of pay for the most senior of a company's executives is, in many cases, likely to form only a small component of total costs. This suggests that the impact of 'excess' quantum on companies, and therefore the productivity and growth prospects of the economy, may also be small. However, if the structure of executive pay distorted decision-making — particularly by CEOs — this could have wider ramifications and impose significant costs on companies and shareholders,

and possibly more broadly. For example, pay structures that encourage undue focus on short-term results, could result in poor investment decisions over time and a less efficient use of resources in the wider economy. Furthermore, if changes in executive remuneration have flow-on effects to other company employees, it is likely to have more significant consequences for total production costs, although the extent to which this effect is present is an empirical matter.

Indeed, the terms of reference note concerns that remuneration structures in the financial sector promoted excessive risk-taking behaviour, and these arrangements have been identified by some groups as a major contributor to the global financial crisis (though, as identified in box 1.5, a range of other forces were at work). For this sector, excessive risk-taking leading to company failures could generate negative system-wide effects. Catastrophic failures in these areas can leave governments with little choice but to use taxpayers' money to bail out companies in difficulty. This means that the community bears (or shares in) costs normally borne by shareholders. This can, in turn, encourage a mismatch between the risk profiles of shareholders and that of the community. This matter is being addressed in several international and domestic fora, including by APRA.

There may be other impacts from both 'excessive' quantum and 'poor' pay structures that could spill over to the wider community. For example:

- if entrepreneurial effort is channelled into trying to maximise or camouflage remuneration, or other distorting behaviour, this could be at the expense of focusing on managing the business
- large disparities between executive pay and average earnings might demotivate a company's employees, adversely affecting productivity and making wage restraint more difficult to achieve during economic downturns
- if high levels of executive pay in some companies spread across other companies through demotivation and ratchet effects.

All of these considerations need to be evaluated and weighed against any efficiency impacts from intervention.

What role for community expectations and societal norms?

The preamble to the terms of reference refers to concerns in the wider community about excessive executive remuneration and the need for a regulatory framework that 'better aligns the interests of shareholders and the community with directors and executives'.

Box 1.5 The global financial crisis: what role for executive remuneration?

There is a common perception that the structure of remuneration in the financial sector (particularly in the United States) was a major contributor to the global financial crisis. However, market analysts have emphasised a number of other factors.

The UK Financial Services Authority observed in the Turner Review:

There is a strong prima facie case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the global financial crisis.

It is very difficult, however, to gauge precisely how important that contribution was. A reasonable judgment is that while inappropriate remuneration structures played a role, they were considerably less important than other factors ... [namely] inadequate approaches to capital, accounting, and liquidity. (FSA 2009b, p. 80)

The International Monetary Fund state that the shadow banking system (investment banks, hedge funds, mortgage brokers, and the like) were lightly regulated by a number of different bodies, and generally not supervised prudentially, and identify this as a contributing factor to the crisis (IMF 2009). It also argues that investors relied too heavily on the advice of credit ratings agencies. Furthermore, too few central banks estimated the build up of systemic risk arising from increases in asset prices and leverage, relying on prudential regulation to control such a build up. The International Monetary Fund observes that the practice of rewarding employees based on the generation of annual profits had pro-cyclical effects that magnified the credit boom, and called for the delinking of bonuses from annual and short-term financial results.

David Gruen (2009), from the Australian Treasury, has proffered five 'proximate causes' of the global financial crisis: global imbalances, low interest rates, US mortgage regulation, housing policies, and flaws in the 'originate to distribute' model for mortgages in the United States. He then identifies three 'wider causes': undue complexity of financial instruments, remuneration incentives in the financial sector to take excessive risks, and higher leveraging within the financial system — noting that the last of these is 'one of the most important'.

While shareholders as a group could once be easily differentiated from the wider community, share ownership has widened considerably since the 1980s and the two groups have become increasingly coextensive (chapter 2). But there are circumstances where their interests (and interests within shareholder, employee and community groups) can diverge. For example:

- shareholders want the companies they invest in to perform well and deliver good returns, which can be at the expense of other companies and their employees and shareholders
- local communities have an interest in seeing the companies located in their regions performing strongly to provide economic stability, but this can be at the expense of other local communities

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- employees have an interest in their companies (and those where their superannuation is invested) doing well in order to deliver stable employment, which can be at the expense of other companies' employees
 - the community at large enjoys the benefits of low priced goods and services delivered through a competitive marketplace, which includes the process of new companies starting-up, and other companies laying off workers to survive, or going bankrupt.

This process of competition and 'creative destruction' is integral to economic growth and means that, while community sentiment about inequality or fairness in relation to executive pay cannot be ignored by governments, neither should the national income consequences of intervention. Ultimately, the community's material wellbeing depends on the efficient operation of companies and markets over time. Organisational innovation and strategic decision-making by senior executives are central to this wealth-creating process. This is recognised in the preamble to the inquiry's terms of reference:

It is also important to recognise that internationally competitive reward structures for company directors and executives continue to provide incentives for directors and executives to assume leadership responsibilities within corporations. (terms of reference, p. 1)

More generally, community 'norms' are often enshrined in legislation in a way that can override individuals' preferences (for example, requirements to wear seatbelts or product safety requirements for food). These norms reflect what the community at large thinks is 'right' or 'fair'. For example, while there is often a focus on the quantum of pay received by some executives, similar concerns are not evident for other, often more highly paid, individuals such as sports stars and entertainers. This suggests that the concerns derive more from the perception that executives can influence their own remuneration (in addition to other key differences in their roles and responsibilities). That is, high pay is accepted where people consider it to have been gained by fair means. It is apparent that many in the community who have raised concerns about executive pay do not think the status quo is delivering fair outcomes (box 1.6) and this underscores the importance of well-functioning pay setting arrangements. That said, there has been relatively little input to this inquiry from individual citizens or shareholders.

Laws that reflect social 'norms' typically in practice also serve to reduce recognised social harms. While it is not clear that concerns about executive pay have such attributes, if community concerns about executive pay led to a lack of confidence in corporate governance more generally, this could have negative implications for capital raising by companies and ultimately, the economic wellbeing of the community itself.

Box 1.6 Public expressions of concern

These bonuses/pay rises ... are obviously immoral, wrong, indecent, crass, obscene ... (Neil Buchanan, sub. 10, p. 1)

... huge payments to CEOs has finally reached crisis proportions. (Klaas Woldring, sub. 8, p. 2)

... the greed-crazed stampede by directors and senior executives to transfer company wealth into their own bank accounts. (Kenneth Park, sub. 21, p. 1)

Executive and CEO pay has increased out of all proportion to that justified by their productivity gains or increases in corporate performance. ... [this] poorly serves the interests of shareholders, employees and the wider community. (Construction, Forestry, Mining and Energy Union of Australia, sub. 78, p. 11)

... ordinary workers are paid low wages, and even lose their jobs as part of cost cutting and efficiency measures that result in higher bonuses and salaries for the executives. (Elizabeth Oldfield, sub. 98, p. 1)

As far as it is ever possible to divine community feelings, it seems the community at large believes that multi-million-dollar salaries or packages are neither justified, warranted, or needed, and are simply 'wrong'. (Andrew Murray, sub. DD112, pp. 2–3)

The simple fact is corporate executives are paid in vast and increasing disproportion to their actual contribution to corporate and community prosperity ... (Adrian Gattenhof, sub. DD120, p. 3)

A problem for government in responding to such concerns is that they may not be based on an adequate understanding of why problems have arisen and the consequences of attempting to fix them. Geoff Hogbin submitted that it is important to:

... consider carefully the weight to be given to possible intangible benefits attributable to, say, satisfying 'community expectations' ... because:

- history has shown that the 'wider community's perceptions' can be inconsistent with the public interest generally (e.g. trade protection was, and is still, believed by many to be beneficial)
- 'the wider community' may not take adequate account of unanticipated, perverse consequences of regulations ... (sub. 99, pp. 2–3)

Questioning of the need to satisfy community expectations in this area is also reflected in RiskMetrics' evidence at public hearings (box 1.7).

While there may be some contention about the role of the community as a stakeholder on matters of executive remuneration, addressing any dysfunction within current governance and regulatory arrangements could deliver a broader public benefit. This holds even if the main impact of such dysfunction is internalised to shareholders and managers.

Box 1.7 ‘Public outrage’: whose interests are most relevant?

Proxy adviser RiskMetrics’ submission documents the numerous concerns it has about remuneration outcomes in Australia, particularly what it sees as questionable linkages between company performance and several highly remunerated executives:

In some cases, based on recent experience in Australia and around the world, it appears that poorly designed incentive structures contributed to the demise of companies, illustrating that while executive remuneration may not be material as an expense it may create material risks. (sub. 58, p. 1)

However, RiskMetrics did not see community expectations as having a particularly strong claim as an input to policy solutions. An exchange at the public hearings illustrates this (trans., p. 378).

Commissioner Fitzgerald: ... In a sense, the public outrage is linked in part to the quantum and in part, particularly, the termination phase. I suppose we’ve asked a lot of participants this: should we be concerned about quantum ...

Mr Paatsch (RiskMetrics): No, you shouldn’t be concerned about it, shareholders should be concerned about it, and if they don’t like it, they should be able to toss the boards out and get new ones, new directors. That’s it.

1.4 Conduct of the inquiry

The Commission has consulted extensively in the preparation of this report (appendix A). In addition to informal consultations and roundtables, 170 submissions have been received — 105 prior to the release of a Discussion Draft, and a further 65 in response to that draft. Many of the submissions were substantial.

An initial round of public hearings in Sydney, Melbourne and Brisbane provided an opportunity for groups and individuals to present evidence before the Commission. Submissions have been received from, and discussions held with:

- CEOs and senior executives
- company chairs and directors
- institutional investors, including funds managers and superannuation funds
- retail shareholders and their representative bodies
- proxy advisers
- remuneration and other corporate consultants
- regulators
- academic researchers.

The Commission released its Discussion Draft, *Executive Remuneration in Australia* (PC 2009) on 30 September 2009. The Commission proposed a package of reforms aimed at improving the accountability of boards, removing conflicts of interest, and enhancing shareholder engagement on remuneration. It sought further submissions on these proposals and held a further round of public hearings in Melbourne and Sydney from late October.

Overwhelmingly, participation has come from those with a *direct* interest in executive pay setting — the associations (for example, the Australian Institute of Company Directors and the Australian Shareholders' Association), companies (for example, BHP Billiton and Macquarie Group), governance consulting firms (for example, Regnan), remuneration consultants (for example, Mercer), proxy advisers (for example, RiskMetrics and CGI Glass Lewis), legal firms (for example, Freehills), unions representing company employees (for example, the Australian Council of Trade Unions) and academic researchers. As noted, there has been relatively little engagement by individual retail shareholders and members of the public.

1.5 Report structure

The structure of this report follows the terms of reference, which essentially ask the Commission to:

- establish the facts about executive remuneration
- assess the effectiveness of the framework of oversight, accountability, and transparency, including shareholder engagement and taxation arrangements
- make recommendations to promote better alignment between the interests of boards and executives with shareholders and the community more broadly.

There are four parts.

Part A outlines the Commission's analytical framework and discusses the rationale for, and evolution of, the public company structure.

Part B presents information on what has happened to the structure and quantum of executive remuneration over time and explores what has driven these outcomes.

Part C provides an analysis of the institutional environment, with assessments of the effectiveness of processes for determining executive pay (chapter 6), how pay is structured and linked to performance (chapter 7), and how boards engage with their shareholders through remuneration reporting (chapter 8) and through voting rights

(chapter 9). The extent to which taxation influences remuneration quantum and/or structure is canvassed (chapter 10).

Because of the interactions that arise among these areas and the scope for policy changes in one area to impact on others, Part D integrates the analysis and findings in seeking to deliver a consistent set of policy proposals.