
5 Overview of the regulatory and corporate governance framework

Key points

- Corporate governance encompasses rules as well as the framework of relationships and processes designed to ensure that company managers and directors act in the interests of the company and, ultimately, shareholders.
- Reflecting changes in companies and market expectations, Australia's corporate governance framework has evolved significantly over time.
- To accommodate diversity and to balance objectives, the regulatory and corporate governance framework comprises a mix of:
 - 'black letter' law, through the *Corporations Act 2001* (Cwlth) and the ASX listing rules
 - 'soft' law, under the ASX Corporate Governance Council principles and recommendations ('if not, why not' reporting)
 - non-regulatory guidelines promulgated by industry organisations.
- The regulatory and corporate governance framework influences:
 - the way boards function
 - how boards choose to link pay to performance
 - disclosure of director and executive pay
 - how effectively boards engage with the company's shareholders.

The terms of reference for this inquiry require the Commission to consider the effectiveness of the framework for the oversight, accountability and transparency of remuneration practices in Australia, including the role of regulatory and non-regulatory industry guidelines and codes of practice.

'Corporate governance' refers to the set of institutions and practices designed to ensure that managers and directors act in the interests of the company and ultimately shareholders. It encompasses:

... 'the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations'. It encompasses the mechanisms by which companies, and those in control, are held to account. (ASX Corporate Governance Council 2007a, p. 3, citing Justice Owen in the HIH Royal Commission)

Thus corporate governance is not simply a product of government regulation. Companies have inherent incentives to establish governance procedures to demonstrate their bona fides to investors, in order to attract capital. Executives also have incentives to deliver good performance to maintain their professional reputations. But rules can reinforce such incentives and diminish the risk of a loss of confidence in a market resulting from poor behaviour of a few.

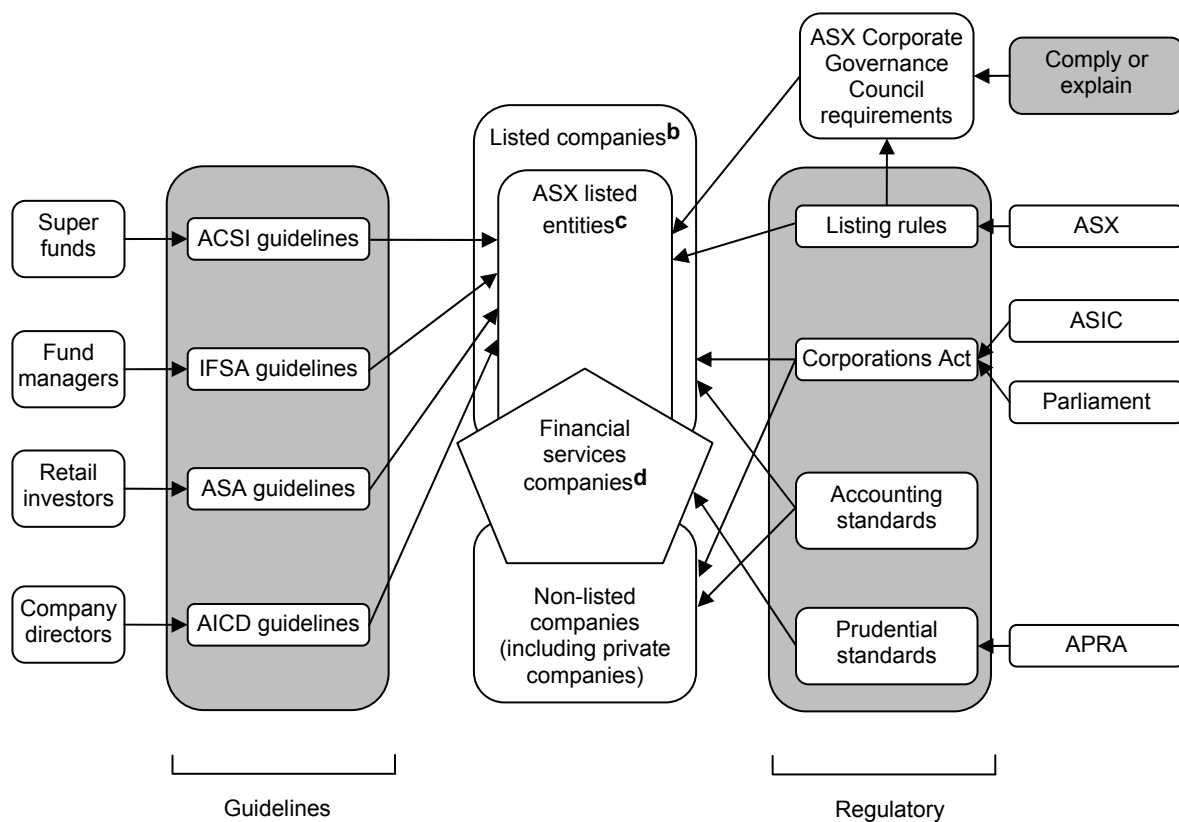
There is no single or enduring best-practice model for corporate governance: different approaches and combinations of approaches can promote alignment and trust, while company structures and market expectations change over time. Indeed, the diversity of companies makes flexible governance arrangements highly desirable — one size is unlikely to fit all. In addition, regulations designed to promote alignment and accountability, if they are excessively prescriptive, have the potential to impede the ability of managers to manage. To accommodate diversity and to balance objectives, Australia’s corporate governance framework has accordingly evolved over time, combining ‘black letter’ law with ‘soft’ law requirements, as well as other industry-based guidance.

Internationally, Australia’s corporate governance framework ranks highly. Australia has consistently been ranked in the top three countries for the efficacy of its corporate boards since 2002-03, according to the World Economic Forum (2008). (Efficacy is assessed by the extent to which survey respondents considered that investors and boards exert strong supervision of management decisions.) Similarly, analysis by GovernanceMetrics International in 2008 ranked the top Australian companies fourth among companies from 38 countries, against criteria such as board accountability, financial disclosure and internal controls, shareholder rights, executive remuneration, market for control and ownership base, and corporate behaviour (GovernanceMetrics International 2008).

5.1 Australia’s current framework

Australia’s regulatory framework for remuneration — and corporate governance more broadly — has over time brought greater disclosure, accountability of directors and involvement of shareholders. The framework is based on a mix of regulations (‘black letter’ law), ‘comply or explain’ guidelines (‘soft’ law) issued by the Australian Securities Exchange (ASX) Corporate Governance Council, and advisory guidelines. Figure 5.1 illustrates how these regulations and guidelines interact.

Figure 5.1 The regulatory and governance framework^a



^a Acronyms are as follows — ACSI: Australian Council of Super Investors; AICD: Australian Institute of Company Directors; APRA: Australian Prudential Regulation Authority; ASA: Australian Shareholders' Association; ASIC: Australian Securities and Investments Commission; ASX: Australian Securities Exchange; IFSA: Investment and Financial Services Association. ^b Listed public companies will predominantly be ASX-listed entities. Exceptions are companies listed on other Australian stock exchanges, such as the National Stock Exchange of Australia and the Bendigo Stock Exchange. ^c Most ASX listed entities would be listed public companies in the context of the Corporations Act. Exceptions include some listed trusts and companies incorporated outside Australia. ^d Some APRA-regulated banks and insurance companies would be ASX-listed entities. However many, including credit unions, building and friendly societies, and superannuation funds are not ASX listed.

The 'black letter' regulatory framework for companies in Australia is centred on the *Corporations Act 2001* (Cwlth) and the ASX listing rules. Together, these form the core of the regulatory requirements placed on companies with regard to issues such as board structure, disclosure, shareholder voting and corporate governance.

The Corporations Act

The Corporations Act is the principal legislation regulating companies. (Prior to 2001, the Corporations Law was contained in a Commonwealth Act that was enacted in the ACT, with State and Northern Territory laws applying the Corporations Law of the ACT.) The Act is obviously much broader in its coverage

than executive remuneration, and includes the framework surrounding the formation of companies and the duties of directors (box 5.1).

The Corporations Act applies, though to differing degrees, to private and public companies and some partnerships and managed investment schemes. Public companies are subject to more stringent disclosure and reporting requirements than private companies.

Box 5.1 The Corporations Act

The Corporations Act provides the statutory basis for the formation of private and public companies, corporate regulation and the regulation of the securities and futures industries.

Although the Australian Constitution provides that the states have jurisdiction over corporations, the states and territories have formally referred their powers on corporations and securities to the Commonwealth. These arrangements are supported by the intergovernmental *Corporations Agreement 2002*. The agreement requires consultation with the states and territories and, in some cases, voting on amendments to the Corporations Act and related legislation (through the Ministerial Council for Corporations). This can have implications for executive remuneration (chapter 9).

The coverage of the Corporations Act is wide ranging, including:

- registration of companies
- membership and internal management (including the duties of directors)
- financial reporting and disclosure
- takeovers
- fundraising
- financial services and markets.

These provisions apply to differing degrees to private and public companies and some partnerships and managed investment schemes. In relation to executive remuneration, for all companies, the role and composition of boards and termination benefits are regulated. For listed companies, the Act regulates disclosure through the remuneration report and voting on remuneration.

With respect to executive remuneration, the Corporations Act has provisions relating to the role, responsibilities and structure of boards; termination payments; and, for listed companies, disclosure (through the remuneration report) and voting on remuneration. Under the Act, the board of directors is responsible for appointing the managing director (CEO), and deciding the composition of the managing director's remuneration package. While not explicitly mentioned in the

Corporations Act, the board also has a key role in setting remuneration for other senior executives.

The Corporations Regulations 2001 also require companies to prepare their annual financial report, including the remuneration report, in accordance with the applicable accounting standards, including valuing share-based payments. Sanctions for breaches of Corporations Act provisions involve fines and, in some cases, imprisonment.

The provisions in the Corporations Act relating to remuneration have strengthened over time, in response to emerging concerns. In particular, disclosure requirements have increased to improve transparency and accountability (box 2.1 in chapter 2). A non-binding vote on the company's remuneration report was introduced in 2004 and, more recently, the threshold for a shareholder vote on termination payments was lowered considerably.

Under the Corporations Act shareholders are responsible for the election of directors. Further, section 203D states that a director may be removed by ordinary resolution of the company. This resolution may be put to the general meeting by shareholders with 5 per cent of the votes that may be cast on the resolution, or at least 100 shareholders (s. 249N). Notice that the resolution is to be put to the meeting must be received by the company at least two months before the meeting.

Many of the reforms to the Corporations Act were implemented under the auspices of the Corporate Law Economic Reform Program (CLERP). This program of sequential reforms, designed to comprehensively improve Australia's corporate law, began in 1997 in response to the Wallis report into the Australian financial system. Central to the program were principles of market freedom, investor protection and quality disclosure of relevant information to the market (Treasury 2002).

CLERP reforms were undertaken in nine stages — commonly referred to as CLERP 1 to 9 — the last of which was enacted in July 2004 (box 5.2). Among other reforms (including in response to the HIH Insurance Royal Commission), CLERP 9 introduced the non-binding vote on remuneration and increased remuneration disclosure.

Box 5.2 Corporate Law Economic Reform Program

The Corporate Law Economic Reform Program (CLERP) involved a series of staged reforms aimed at improving Australia's corporate law.

- CLERP 1 reformed the accounting standard-setting process, and included reconstituting the Australian Accounting Standards Board and establishing the Financial Reporting Council.
- CLERP 2 reduced the cost of fundraising for Australian companies by improving disclosure and reducing transactions costs.
- CLERP 3 focused on directors' duties and corporate governance, and included the introduction of a 'business judgment rule'.
- CLERP 4 reformed takeover regulation, including notification requirements and procedures.
- CLERP 5 facilitated electronic commerce, including improved flexibility for electronic lodgment and inspection of information.
- CLERP 6 involved significant reform to financial services markets, establishing a regulatory framework for the financial services industry and establishing the Australian Prudential Regulation Authority.
- CLERP 7 simplified document lodgment and compliance procedures.
- CLERP 8 enacted a model law on cross-border insolvency, developed by the United Nations Commission on International Trade Law.
- CLERP 9 aimed to improve the operation of the market by promoting transparency, accountability and shareholder activism. With respect to executive remuneration, it extended the scope of remuneration disclosure, introduced the non-binding vote on the remuneration report and required shareholder approval for retirement benefits for directors and managerial officers.

Source: Treasury (2009c).

ASX listing rules

The ASX listing rules deal with the requirements for listing and quotation, market information, trading and settlement, and general supervisory matters. The rules apply to all companies and trusts (entities) listed on the ASX. Most of these entities will also be subject to the requirements of the Corporations Act (exceptions include some listed trusts and companies incorporated outside Australia). ASX listing rules date from the formation of the Australian Stock Exchange in 1987, but like the Corporations Act have evolved over time.

The listing rules are designed to protect investors and the reputation of the market, while taking into account the interests of listed entities (ASX 2009f). The ASX sets

these rules, but under the Corporations Act, any amendments must be lodged with the Australian Securities and Investments Commission and are subject to disallowance by the relevant Minister.

Key listing rules affecting executive remuneration relate to continuous disclosure, issuing shares to related parties, voting on non-executive director remuneration, reporting against the ASX Corporate Governance Council's recommendations (discussed further below) and some voting exclusions (box 5.3).

Listed companies and trusts enter into a binding contractual relationship with the ASX to comply with its listing rules. In addition, the rules are enforceable under the Corporations Act against listed entities and their associates (ASX 2009f). A breach of the ASX listing rules can result in a variety of sanctions against the company — ranging from censure or compulsory director education for minor breaches, to suspension or fines of up to \$1 million for serious breaches (ASX 2008b).

APRA and financial services businesses

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the financial services industry, including banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. A key reason for specialised regulation of the financial services industry is the risk of third party losses and impacts on the wider financial system from individual corporate failures.

Some companies regulated by APRA are also subject to the Corporations Act and the ASX listing rules. However, many — including credit unions, building and friendly societies, and superannuation funds — are not listed. Those that have issued debentures are subject to the Corporations Act.

APRA recently finalised and released a set of prudential standards that would require APRA-regulated businesses to have a remuneration committee and a remuneration policy that aligns remuneration with risk management. These standards come into effect on 1 April 2010 (box 5.4).

Box 5.3 ASX listing rules affecting executive remuneration

ASX listing rules affecting executive remuneration relate to the following areas.

- Disclosure:
 - continuous disclosure — once an entity becomes aware of information that a reasonable person would expect to have an effect on the entity's securities, the entity must immediately inform the ASX. Under this rule, when a senior executive is appointed, the entity must immediately disclose to the ASX the contractual terms (listing rule 3.1)
 - the extent to which the ASX Corporate Governance Council's recommendations have been complied with, and if not, reasons why (listing rule 4.10.3).
- Non-executive director remuneration and re-election:
 - an entity must not increase the total amount of director fees payable without shareholder approval by ordinary resolution (this rule does not apply to executive directors) and non-executive director remuneration must be a fixed sum (listing rule 10.17)
 - directors must submit for re-election at the third annual general meeting following appointment, or after three years, whichever is longer (the rule does not apply to the managing director/CEO of the entity — if there is more than one managing director, only one is not subject to re-election) (listing rule 14.4).
- Other shareholder voting:
 - for a director to obtain a substantial asset (valued at more than 5 per cent of the company's outstanding equity) from the company (listing rule 10.1)
 - for the issue of shares to a related party (including a director) (listing rule 10.11)
 - for a director to obtain equities under an incentive scheme, that are not purchased on the market (listing rule 10.14)
 - for total termination benefits that exceed 5 per cent of the company's equity (listing rule 10.19)
 - for the issue of total equity, within a 12 month period, that exceeds more than 15 per cent of outstanding equity (listing rule 7.1)
 - voting exclusions for certain resolutions including those relating to issuing equity, the directors' fee pool and significant termination payments (various listing rules).
- Prohibits a senior executive receiving a termination payment due to a change in the control of the company (listing rule 10.18).

Sources: ASX listing rules.

Box 5.4 APRA's review of regulatory arrangements for remuneration in financial institutions

APRA has finalised its consideration of remuneration for authorised deposit-taking institutions and general and life insurance companies, following a request from the Prime Minister to consider links between remuneration and capital adequacy requirements. APRA's proposals also implement the Financial Stability Forum's *Principles of Sound Compensation Practices*, endorsed by the G-20 in April 2009 (APRA 2009b). APRA released its finalised governance prudential standards and prudential practice guide on 30 November 2009, to be effective from 1 April 2010.

APRA's approach to remuneration, in broad terms, focuses on the structure, rather than quantum, of remuneration (APRA 2009a, 2009d). APRA views the board of directors as ultimately responsible for remuneration. However, it proposes two key extensions to existing governance standards — requiring boards to establish, maintain and periodically review a written remuneration policy, and requiring boards to establish a remuneration committee (APRA 2009c).

Remuneration policy

The remuneration policy covers all persons or classes of persons within the institution who, given their roles, have the ability to make decisions that could put the institution's financial soundness at risk. Employees covered by the remuneration policy include: 'responsible persons' (generally directors, executives and senior managers), risk and financial control personnel, and other staff who have a significant share of remuneration that is performance-based (such as bonuses and commissions). Non-executive directors however, are excluded.

Remuneration committees

Remuneration committees should comprise only non-executive directors, with a majority independent and an independent chair (consistent with audit committee requirements). The remuneration committee should be responsible for periodically reviewing the institution's remuneration policy (at least every three years) and making annual recommendations to the board on the remuneration of the CEO, direct reports to the CEO, persons whose activities may affect the financial soundness of the institution, and any other person specified by APRA. APRA may grant approval to an institution not to have a remuneration committee if the board has alternative arrangements in place that achieve the same result.

Risk

APRA's prudential practice guide (to assist institutions comply with the requirements) states that sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets. APRA suggests that generally, prudent practice entails a substantial portion of performance-based remuneration being deferred and at risk for an extended period. APRA indicates that measuring performance by profits or earnings may be appropriate in some cases, but effective remuneration arrangements will include adjustments for risk, including future risks not identified or measured by accounting profits (2009b).

ASX Corporate Governance Council's principles and recommendations

Complementing the statutory or 'black letter' law requirements are 'soft' law corporate governance principles and recommendations of the ASX Corporate Governance Council, which have some regulatory force. The council's key recommendations on board structure and remuneration are presented in box 5.5.

Box 5.5 ASX Corporate Governance Council's principles and recommendations on board structure and remuneration

The first edition of the ASX Corporate Governance Council's corporate governance principles and recommendations was released in 2003 (ASX Corporate Governance Council 2003). Revised principles and recommendations were issued in 2007.

The principle on structuring the board (principle 2) contains four 'comply or explain' recommendations:

- the board should be made up of a majority of independent directors (recommendation 2.1)
- the chair should be an independent director (recommendation 2.2)
- the chair and the chief executive officer should not be the same person (recommendation 2.3)
- a nomination committee should be established (recommendation 2.4) (ASX Corporate Governance Council 2007).

The principle on remuneration (principle 8) states 'companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear' (ASX Corporate Governance Council 2007, p. 35). It contains three recommendations:

- the board should establish a remuneration committee (recommendation 8.1)
- companies should clearly distinguish the structure of non-executive director remuneration from executive remuneration (recommendation 8.2)
- the board should provide the following information (recommendation 8.3):
 - the names of the members of the remuneration committee or, if the company does not have a remuneration committee, how its functions are carried out
 - the existence and terms of any retirement benefit schemes (other than superannuation) for non-executive directors
 - a summary of the company's policy on hedging unvested performance pay.

The ASX Corporate Governance Council involves a mix of 21 business, investment and shareholder groups (including representatives of many of the authors of key advisory guidelines, as discussed below). The council was established in 2002 to

develop and deliver an industry-wide, supported framework for corporate governance that would provide a practical guide for listed companies, their investors and the wider Australian community.

Reflecting the diversity of listed companies, a cornerstone of the principles and recommendations is flexibility, balanced with accountability. Companies are not *required* to comply with the ASX Corporate Governance Council's recommendations. However, under ASX listing rule 4.10.3, they must disclose whether they have complied with the recommendations and if they have not, provide a public explanation (the 'if not, why not' rule).

Advisory guidelines

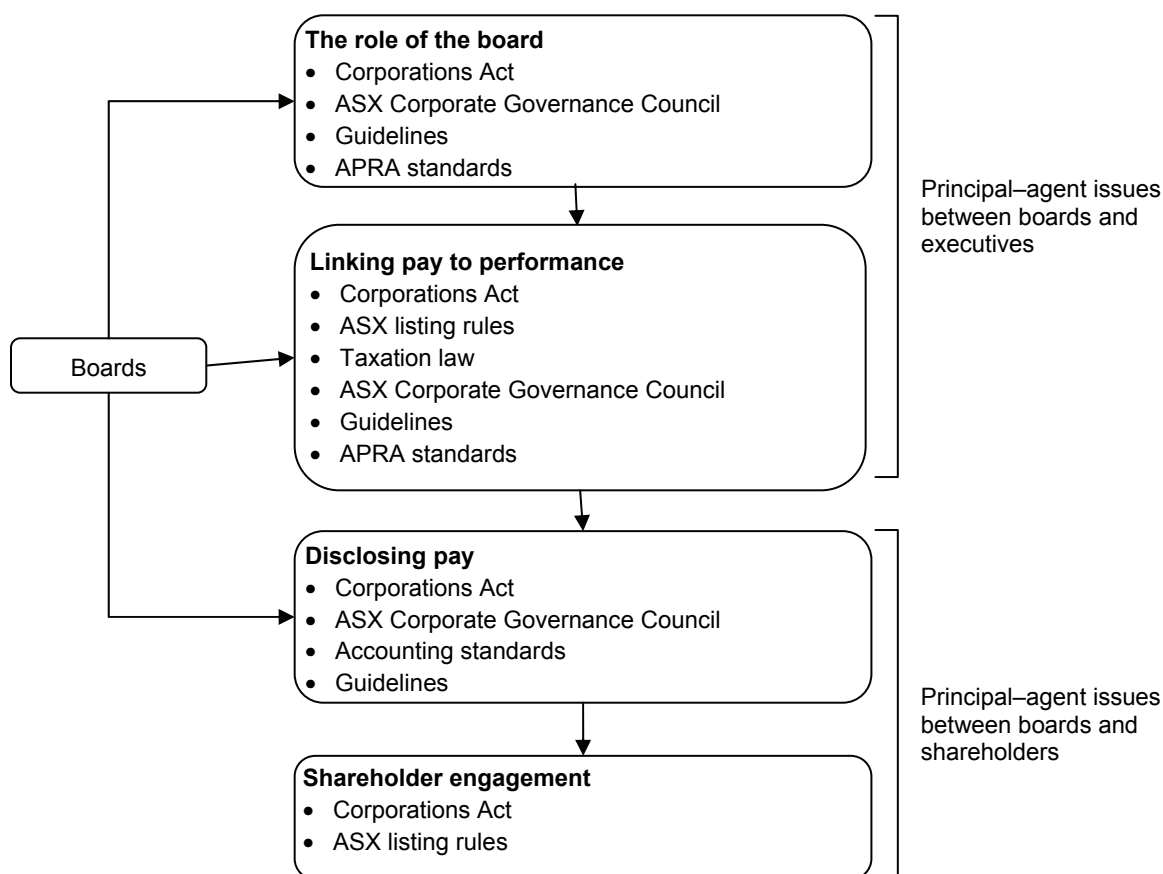
Other guidelines are issued by organisations such as the Australian Council of Super Investors, the Australian Shareholders' Association, the Australian Institute of Company Directors and the Investment and Financial Services Association. These organisations cover a variety of key stakeholders, including both institutional investors (organisations such as superannuation funds and mutual funds) and retail investors (individuals). While their guidelines are directed at boards, they also give their members a point of reference when engaging with companies and voting on corporate governance matters.

In addition, individual institutional investors and proxy advisers (who offer advice to institutions on how to vote their shares, such as RiskMetrics and CGI Glass Lewis) often follow their own guidelines when deciding or recommending how to vote. Thus such guidelines can influence remuneration practices through the threat of a negative vote on companies' remuneration reports or at board elections.

The 'framework' for remuneration

Taking into account the above regulatory requirements, the remuneration framework focuses on the role of the board in setting remuneration, including linking pay to performance, remuneration disclosure, and shareholder voting. Figure 5.2 depicts the elements of this framework, and the main regulations and guidelines affecting each, broken down according to the two agency relationships involved. Table 5.1 highlights which regulations and/or guidelines affect different aspects of remuneration.

Figure 5.2 How regulations affect the executive remuneration framework



To assist in determining an appropriate executive remuneration package, guidelines recommend boards establish a remuneration committee, and seek independent external advice from remuneration consultants. Remuneration packages typically comprise fixed pay, and short- and long-term incentive payments. These can be in the form of cash or equity. Each of these forms of pay have different guidelines and regulations surrounding their use. For example, non-recourse loans, termination payments and the use of hedging for unvested incentive payments all feature prominently within advisory guidelines (table 5.1). Taxation provisions can also influence the structure of remuneration.

Each year, companies are required under the Corporations Act to produce a ‘remuneration report’ as part of their annual report. The Act specifies the information that needs to be provided in the report. Shareholders have a (non-binding or advisory) vote on this report at the annual general meeting. They also have a binding vote on termination payments above a certain threshold (recently reduced), as well as on remuneration involving the issue of equity to directors, and the election of directors (chapters 8 and 9).

Table 5.1 **Remuneration regulation^a**

	<i>Regulatory/'comply or explain'</i>				<i>Guidelines</i>			
	<i>Corporations Act</i>	<i>ASX listing rules</i>	<i>APRA</i>	<i>ASX CGC</i>	<i>AICD</i>	<i>ACSI</i>	<i>ASA</i>	<i>IFSA</i>
The role of the board								
Composition of boards	✓			✓	✓	✓	✓	✓
Remuneration committee			✓	✓	✓	✓		✓
Remuneration consultants			✓		✓	✓		
Linking pay to performance								
Equity-based pay		✓	✓		✓	✓	✓	✓
Non-recourse loans					✓	✓	✓	✓
Hedging	✓		✓	✓		✓	✓	
Termination benefits	✓	✓	✓		✓	✓	✓	
NED remuneration		✓		✓	✓	✓	✓	
Disclosing pay								
Remuneration report	✓			✓	✓	✓	✓	✓
Executive contract		✓						
Shareholder engagement								
Issue of equity		✓			✓			✓
Termination benefits	✓	✓			✓			
Remuneration report	✓				✓			
NED remuneration		✓						

^a Acronyms are as follows — ACSI: Australian Council of Super Investors; AICD: Australian Institute of Company Directors; APRA: Australian Prudential Regulation Authority; ASA: Australian Shareholders' Association; ASIC: Australian Securities and Investments Commission; ASX: Australian Securities Exchange; ASX CGC: Australian Securities Exchange Corporate Governance Council; IFSA: Investment and Financial Services Association.

Sources: ACSI (2009a); AICD (2004, 2009b); APRA (2009b, 2009c); ASA (2009); ASX listing rules; ASX Corporate Governance Council (2007a); *Corporations Act 2001* (Cwth); IFSA (2009).

The process for determining remuneration for non-executive directors differs from that for executives. Shareholders have a *binding* vote on any increases to the total pool of non-executive director fees. Once this pool is determined, the board can

then decide how to allocate the fees. Generally the pool is divided equally, with additional fees allocated to directors on committees, the chairs of the committees and the chair of the board.

5.2 Approach to assessing effectiveness

The evaluation task entailed in meeting the terms of reference to assess the effectiveness of the regulatory and corporate governance framework is presented in five chapters in this part of the report. Specifically, part C assesses how the existing framework influences and constrains boards in relation to their deliberations on pay quantum, pay structure and engagement with shareholders. The chapters are structured to reflect the remuneration framework presented in figure 5.2 and table 5.1.

The following two chapters focus on the framework primarily addressing principal–agent issues between boards and executives. The role of the board, including the use of remuneration committees and remuneration consultants, is assessed in chapter 6. Linking pay to performance is discussed in chapter 7.

Agency issues between boards and shareholders are addressed through shareholder engagement in remuneration processes and outcomes, including remuneration disclosure (primarily the remuneration report) and shareholder voting. The effective functioning of disclosure and the remuneration report is assessed in chapter 8 and other shareholder engagement areas are discussed in chapter 9.

The final chapter in part C deals with taxation (chapter 10). Boards essentially take tax arrangements as given, but they can respond to tax-induced incentives in different ways. That said, taxation arrangements have wider implications than just executive remuneration and this is reflected in the scope of that chapter.

In all of these areas, Australia’s current arrangements are compared with international approaches. Effectiveness is assessed, problems identified and possible improvements are discussed. However, given the significant overlaps and interactions between ‘black letter’ law, ‘soft’ law and regulatory guidelines, in tandem with the potential for policy changes in one area to affect others, the analysis and conclusions in part C are considered in a more integrated way in part D along with policy options.