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# OVERVIEW

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## Key points

- Strong growth in executive remuneration from the 1990s to 2007, and instances of large payments despite poor company performance, have fuelled community concerns that executive remuneration is out of control.
- Pay for CEOs of the top 100 companies appears to have grown most strongly, at 13 per cent real a year, from the mid-90s to 2000, and then increased by around 6 per cent annually in real terms to 2007. Since 2007 average remuneration has fallen by around 16 per cent a year, returning it to 2004-05 levels.
  - The rise and decline in executive pay over the 2000s largely reflects increased use of pay structures linked to company performance.
- Executive pay varies greatly across Australia's 2000 public companies.
  - For the top 20 CEOs, in 2008-09 it averaged \$7.2 million (110 x AWE) compared to around \$260 000 for CEOs of the smallest listed companies (4 x AWE).
  - Generally speaking, Australian executives appear to be paid in line with smaller European countries, but below the UK and USA (the global outlier).
- Liberalisation of the Australian economy and global competition, increased company size, and the shift to incentive pay structures, have been major drivers of executive remuneration — companies compete to hire the best person for the job, and try to structure pay to maximise the executive's contribution to company performance.
- Nonetheless, some past trend and specific pay outcomes appear inconsistent with an efficient executive labour market, and possibly weakened company performance.
  - Incentive pay 'imported' from the United States and introduced without appropriate hurdles spurred pay rises in the 1990s partly for 'good luck'. More recently, complex incentive pay may have delivered unanticipated 'upside'.
  - Some termination payments look excessive and could indicate compliant boards.
- Instances of 'excessive' payments and perceived inappropriate behaviour could also reduce investor and community trust in the corporate sector more broadly, with adverse ramifications for equity markets.
- But the way forward is not to by-pass the central role of boards. Capping pay or introducing a binding shareholder vote on it would be impractical and costly.
- Instead, the corporate governance framework should be strengthened by:
  - removing conflicts of interest, through independent remuneration committees and improved processes for use of remuneration consultants;
  - promoting board accountability and shareholder engagement, through enhanced pay disclosure and strengthening the consequences for those boards that are unresponsive to shareholders' 'say on pay'.
- These reforms would significantly reduce the likelihood in future of inappropriate remuneration outcomes, or those that shareholders would find objectionable.

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# Overview

A catalyst for this inquiry was concern that executive pay had got out of hand. This perception was fuelled by practices in financial institutions abroad that were seen as a key contributor to the global financial crisis (GFC). Further, while local shareholder value plummeted in 2008 as a result of that imported crisis — with some companies and sectors being propped up by taxpayers — executive pay seemed to emerge unscathed, crystallising a view that executives were being rewarded for failure (after having been rewarded for success).

This has come on top of longstanding community discomfort about the widening gap between the remuneration of executives and other employees, as well as some large termination payments with perceived lack of justification. Public opinion polling over the years consistently shows that most respondents believe executives to be overpaid. But polls also reveal limited awareness of the drivers of executive pay and wealth creation.

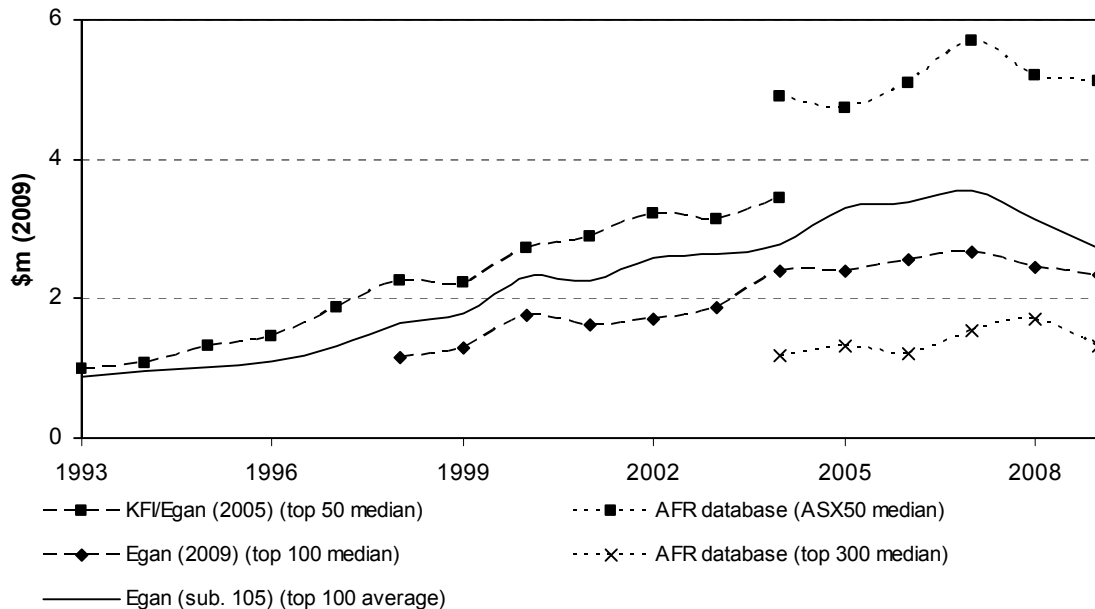
Accordingly, this inquiry was tasked with ascertaining what has actually happened to executive pay in Australia's publicly-listed companies, as well as identifying what can and should be done about it. The appropriate test for any policy intervention is that it promotes community wellbeing: hence the Commission has explored the likely drivers of executive pay and the economic implications of current pay levels and structures. Ultimately, judgment must be exercised, particularly in relation to the magnitude of identified problems and the case for intervention, taking into account both the potential costs and benefits.

## **Some 'facts' about executive pay**

Notwithstanding a lack of consistent data over the longer term, on any measure remuneration for executives of larger companies has grown strongly overall since the early 1990s (figure 1). Depending on the sample used, CEO remuneration at the 50–100 largest Australian listed companies increased between 1993 and 2007 by as much as 300 per cent in real terms. Since 2007, this trend has been reversed to some degree, with pay returning to levels recorded in 2004-05. (The story for non-CEO executives is similar, but with slightly lower growth rates and much lower levels.

Pay for non-executive directors (NEDs) — which is paid as a fixed amount in cash or shares — grew by around 9 per cent per year from 1993 to 2007.)

**Figure 1 Trend executive pay growth in large companies**



In 2008-09, estimated total remuneration for CEOs of the top 20 companies averaged approximately \$7.2 million, or 110 times average wages (figures 2 and 3). CEOs of the next 20 biggest companies had remuneration packages valued about one third less (approximately \$4.7 million). Multi-million dollar packages all but disappear for companies ranked 150–200, while for the smallest of Australia’s almost 2000 publicly-listed companies, CEO remuneration averaged around \$260 000 (or approximately four times average wages).

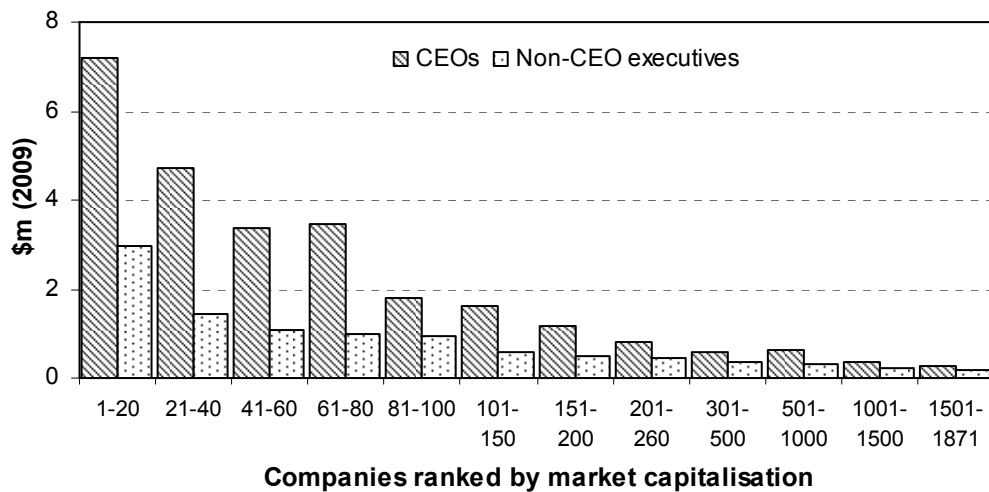
Remuneration levels also vary significantly across industries, being highest in the finance, telecommunications and consumer sectors, and lowest for the CEOs of information technology and utility companies.

While there are no consistent long-run time series for executive pay (because of evolving disclosure rules), the different series available suggest:

- CEO pay grew most strongly from the mid 1990s to 2000 — at around 13 per cent a year in real terms for the top 100 companies and 16 per cent for the ASX50
- from 2000 to 2007, annual real growth moderated to 6 per cent for the top 100 companies, but still led to a 50 per cent increase overall

- between 2006-07 and 2008-09, real total CEO pay fell across ASX300 companies, especially for the top 100 (which have proportionately more pay linked to company performance). The decline in average total remuneration for CEOs of ASX100 companies over the two-year period was approximately 16 per cent per year, in real terms.

**Figure 2 Executive pay rises with market capitalisation**  
2007-08



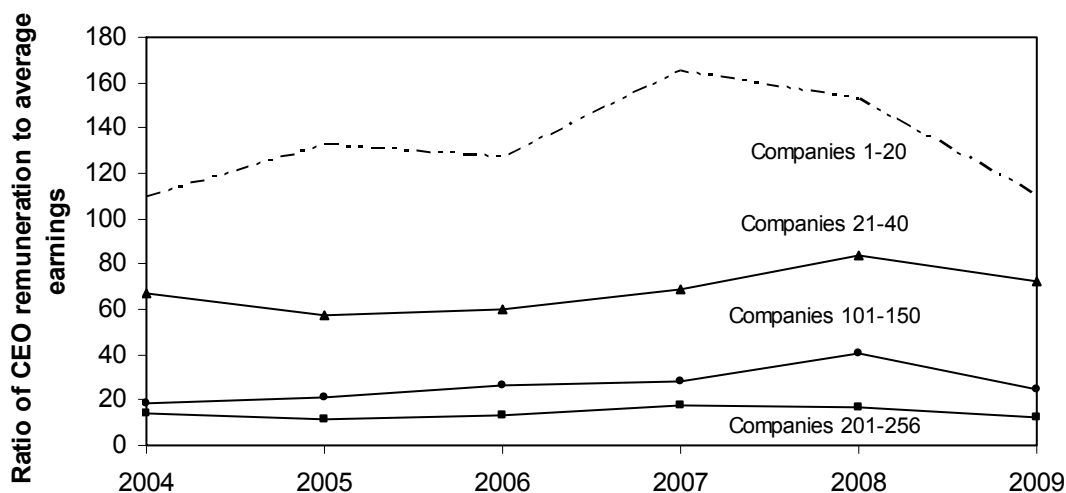
With growth rates for executive remuneration exceeding growth in average weekly earnings for nearly two decades, the gap between them widened, especially for the largest companies (figure 3). However, since 2006-07 the gap has narrowed somewhat, returning to levels observed between 2004 and 2006.

Nearly all of the growth in reported CEO pay for the top 300 companies in the years preceding the GFC was attributable to increases in incentive pay (as valued for accounting purposes), especially ‘long-term’ incentives, which tripled between 2004 and 2007. The extent to which there was any initial trade-off with base pay (cash-in-hand) or other unreported rewards such as fringe benefits is unclear, though average base pay has declined somewhat in real terms in more recent years. Since 2007, long-term incentives (LTIs) have fallen by around 25 per cent and the decline in short-term incentives (STIs) (‘bonuses’) has been even greater.

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Figure 3 Earnings multiples vary with company size

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### Why has executive pay grown so strongly?

There have been a number of drivers of executive pay in Australia over the past 20 years, some of which relate to demand and supply pressures and developments, while others revolve around corporate governance and the implementation of incentive pay structures intended to address principal-agent issues.

#### *Globalisation, increased company size and competition for top talent*

Liberalisation of Australia's product and financial markets together with the introduction of competition in many formerly government-controlled sectors in the 1980s and 1990s, drove substantial domestic structural change, including corporate consolidation and the emergence of internationally-competitive companies with global operations. Today, for example, BHP Billiton (Australia's largest listed company) has a market capitalisation of some \$200 billion, compared to \$16 billion in 1989 at the end of the high protection era. Wesfarmers' capitalisation increased from \$800 million to around \$26 billion over the same period.

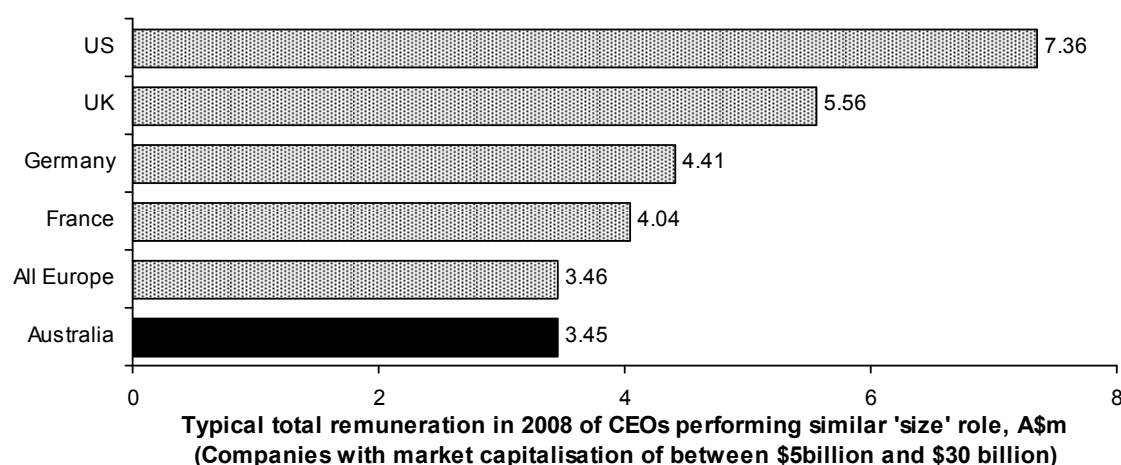
The pay-offs for these and other large companies operating in competitive markets from having a highly-talented CEO and senior executives (and the losses from having inferior ones) are potentially commensurately large. In line with their global focus, many companies now demand candidates with international experience. At the same time, Australian (and other) executives have become more mobile across companies and internationally.

While Australian data constrain the scope for long-term time series analysis, the results of a simple regression analysis of the effect of changes in company size on changes in Australian CEO pay for the 2000s accord with overseas and local research — a 10 per cent increase in company size seems to be associated with around a 4 per cent increase in CEO pay. This same relationship (with opposite sign) can be observed during the recent decline in market capitalisation. While the relationship is not present precisely for every company, broadly speaking, bigger companies seem to be prepared to pay more — both to compensate for increased job importance and complexity and to attract the most talented people. In sum, company size seems to explain 25–50 per cent of observed increases in executive pay.

The increased mobility of executives, coupled with the very high levels of executive pay in the United States (which is the outlier globally), has also had flow-on effects to Australia — for example, through the ‘importation’ of a few high profile US executives to key CEO positions in the early 1990s. These appointments essentially introduced US-style incentive-based remuneration structures to Australia, although such a trend was probably inevitable.

Since then, a number of CEOs have been recruited abroad (for example, 5 of 28 new CEOs for the top 50 companies between 2003 and 2007). That said, Australian executive remuneration levels generally remain below those in the United States and the United Kingdom, being more in line with smaller European economies (figure 4).

**Figure 4 CEO remuneration is closer to the European average**



This could reflect non-pecuniary benefits or lower costs of living in Australia, or for US CEOs, the much higher share of at-risk pay (which commands a risk premium).

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It could also indicate that US pay has become distorted, and that Australian companies simply do not consider candidates who command such rates.

There is some evidence that remuneration of CEOs in the Australian finance sector is closer to US pay levels (for similar sized banks), possibly reflecting higher mobility and global integration in that sector and the dominance of New York and London.

#### *Did enhanced disclosure trigger pay ratcheting?*

Since 1998, individual disclosure of the remuneration of the top executive earners in all listed companies has been required. (Before then, executive pay was reported by pay ‘band’.) Some participants argued that public disclosure of individuals’ pay triggered a pay spiral, as companies and executives sought to ‘position’ themselves in the market, with no one wishing to be seen as hiring or being a ‘below average’ executive. This is sometimes characterised as the ‘Lake Wobegon’ effect — a mythical place from US public radio where ‘... all the children are above average’.

But there is no clear evidence of an acceleration in the growth of executive remuneration in aggregate following introduction of the new disclosure rules. Indeed, the rate of increase in pay slowed in the 2000s compared to the late 1990s. The reversal in executive remuneration since 2007 also indicates that not all companies are locked into providing above average remuneration.

Nonetheless, by improving access to market comparator information for both executives and boards, public disclosure is likely to have led to more rapid flow-on effects where, for example, one company in an industry disturbs relativities by paying an overseas appointee a significantly higher level of remuneration.

#### *More pay for improved performance, or just more pay?*

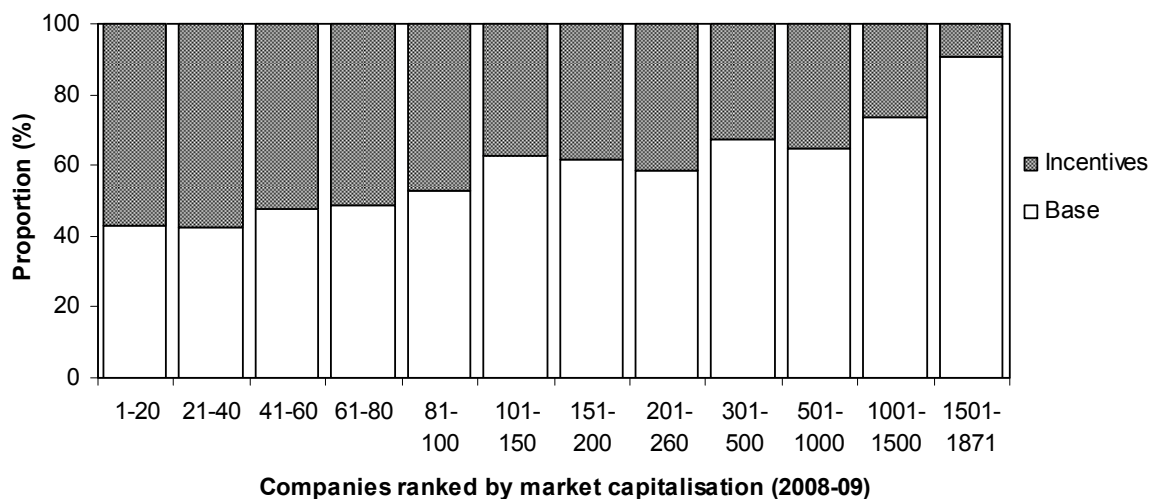
Since the 1990s, the composition of remuneration for senior executives in Australia has changed fundamentally, with a greater focus being placed by boards (and shareholders) on equity-based remuneration, such as options and ordinary company shares (LTIs), and other performance-based forms of remuneration, such as short-term bonuses (STIs) (table 1).

**Table 1 The increasing share of incentive pay in total pay (%)**

ASX300	CEOs			Non-CEO executives		
	Base	STI	LTI	Base	STI	LTI
2003-04	59	30	11	67	23	10
2006-07	40	34	26	45	32	23
2007-08	43	29	28	45	29	27
2008-09	50	25	25	57	21	22

Granting performance-based pay can make sense for companies, because it has the potential to reduce the ‘agency costs’ that would result from executives being paid fixed cash amounts regardless. Agency costs include the costs of executives putting their efforts into decisions that promote their own interests and agendas, but are not in the best interests of the company, as well as the costs incurred monitoring them to make sure this does not happen. As these costs tend to be higher for larger companies (because of more dispersed ownership and the potentially greater influence of executives over company assets), they might be expected to rely more heavily on incentive pay, and the data lend broad support to this (figure 5).

**Figure 5 Incentive pay is proportionately bigger for bigger companies**



Incentive pay will generally involve greater monetary cost for companies than fixed pay, because of the additional risks for the executive (box 1). In principle, boards will be prepared to pay executives a risk premium *if* they consider that the associated incentives (at least) improve company performance commensurately over time. In this sense, incentive pay can be a positive sum game, with rewards accruing to both the executive and shareholders.

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However, while greater use of incentive pay has almost certainly led to higher reported pay over time, in practice, it might not have translated to improved company performance. Compliant boards, or the difficulties posed for them by very complex incentive pay arrangements, could allow executives to mould performance measures and hurdles in their favour, so that ‘at risk’ pay becomes a virtual certainty, perhaps even rewarding and encouraging poor performance. (This is popularly known as the managerial power hypothesis — box 2.)

**Box 1 Riskier pay requires a risk premium**

Incentive pay can promote alignment of managerial and shareholder interests. However, from the perspective of executives it:

- introduces uncertainty about the level of remuneration eventually received (because performance hurdles are not trivial or are susceptible to forces outside their control)
- can constrain their ability to diversify their wealth, exposing them to portfolio risk

Thus, executives will require a ‘risk premium’ compared to a fixed cash salary. The premium required will vary with the risk aversion of the executive and the uncertainties attached to the particular pay hurdles and share price volatility for different companies.

**Box 2 The essential conditions for ‘managerial power’**

According to Bebchuk and Fried, US executives dominate boards to such a degree they effectively set their own pay, subject only to so-called ‘outrage’ costs and constraints, that is, negative reaction by shareholders, the business media and others which can lead to reputational embarrassment.

In their view, executives (and compliant boards) have ‘camouflaged’ remuneration arrangements to limit external scrutiny of rising pay, using complex and hidden vehicles such as options, termination pay and company loans, that are not linked to performance hurdles. Camouflage is more likely where:

- boards are not ‘independent’ or procedures for setting pay are conflicted (and therefore susceptible to CEO influence)
- boards do not have the competencies to fully understand complex pay instruments
- there is limited remuneration disclosure and limited scope for shareholders to voice their (dis)approval.

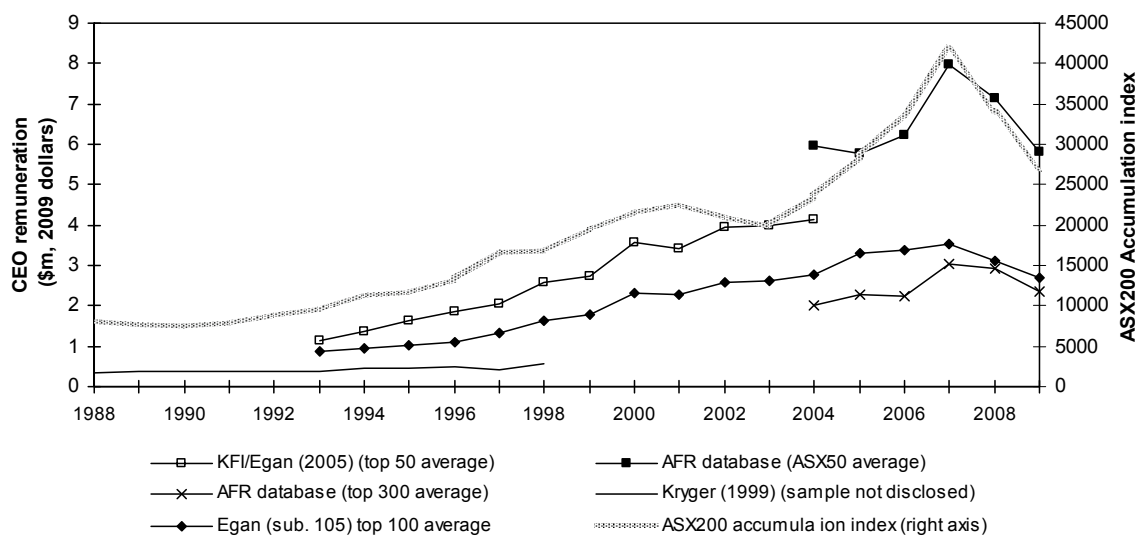
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## Has executive pay been 'efficient'?

It has not been possible to ascertain conclusively whether executive pay in Australia has been appropriately set by boards. On the one hand, there are various indicators in favour:

- There has been a strong correlation between pay and company performance in aggregate, both in good times and bad (figure 6).
  - Demonstrating this relationship at a more disaggregated level has proved difficult in the absence of detailed information about performance targets, the extent of executives' total 'skin in the game', their risk preferences and the level of pay risk
- Options (which can deliver large returns in rising markets) and hidden company loans have not been widely adopted in Australia compared to the United States, and long-term incentive hurdles (at least since the early to mid 2000s) have been increasingly linked to shareholder return relative to comparable companies, constraining excessive rewards for 'good luck'.

Figure 6 **Executive pay has tracked the accumulation index**



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- On a range of indicators, the boards of larger Australian companies appear to be relatively independent, with many adopting procedures (including remuneration committees) that would be expected to reduce the potential for senior executives to directly influence the setting of their own pay (box 3).

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- Australian boards have also been made increasingly accountable on remuneration matters through disclosure requirements and the (non-binding) shareholder vote on the remuneration report — which Bebchuk, for example, considers should be introduced in the United States to ‘move pay arrangements toward those that best serve shareholder interests’.

**Box 3      Australia’s corporate governance rates well**

- Australian boards are generally smaller than US boards, with few dual CEO/chairs (particularly for larger companies), and a higher proportion of non-executive directors (NEDs) and ‘independents’. Independent NEDs comprise a majority of most ASX300 company boards.
- Most large Australian companies have remuneration committees.
  - Around 75 per cent of remuneration committees in larger companies comprise only NEDs, and most remuneration committees in the top 400 companies comprise mainly *independent* NEDs, and have an independent chair.
- Each year listed companies must produce a remuneration report with pay details for top executives. Shareholders have a non-binding vote on this report.

The World Economic Forum has consistently ranked Australia in the top three countries for corporate governance since 2002-03. GovernanceMetrics International (2008) ranked corporate governance in top Australian companies fourth of 38 countries.

On the other hand, there are some reasons for having doubts:

- Not all public companies meet best practice guidelines for remuneration setting. While many of these are at the smaller end of the scale, a significant minority of remuneration committees of large companies include an executive member, and might also receive remuneration advice from consultants who undertake other work for the CEO, or who might not report directly to the board.
- Some very large termination payments appear difficult to reconcile with company and shareholder interests.
- Incentive pay invariably is challenging to design and seems to have been introduced in the 1990s without adequate understanding by some boards, with ‘permissive’ hurdles delivering strong pay growth in that decade (box 4).

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#### Box 4      **Incentive pay: more art than science?**

Incentive pay typically comprises:

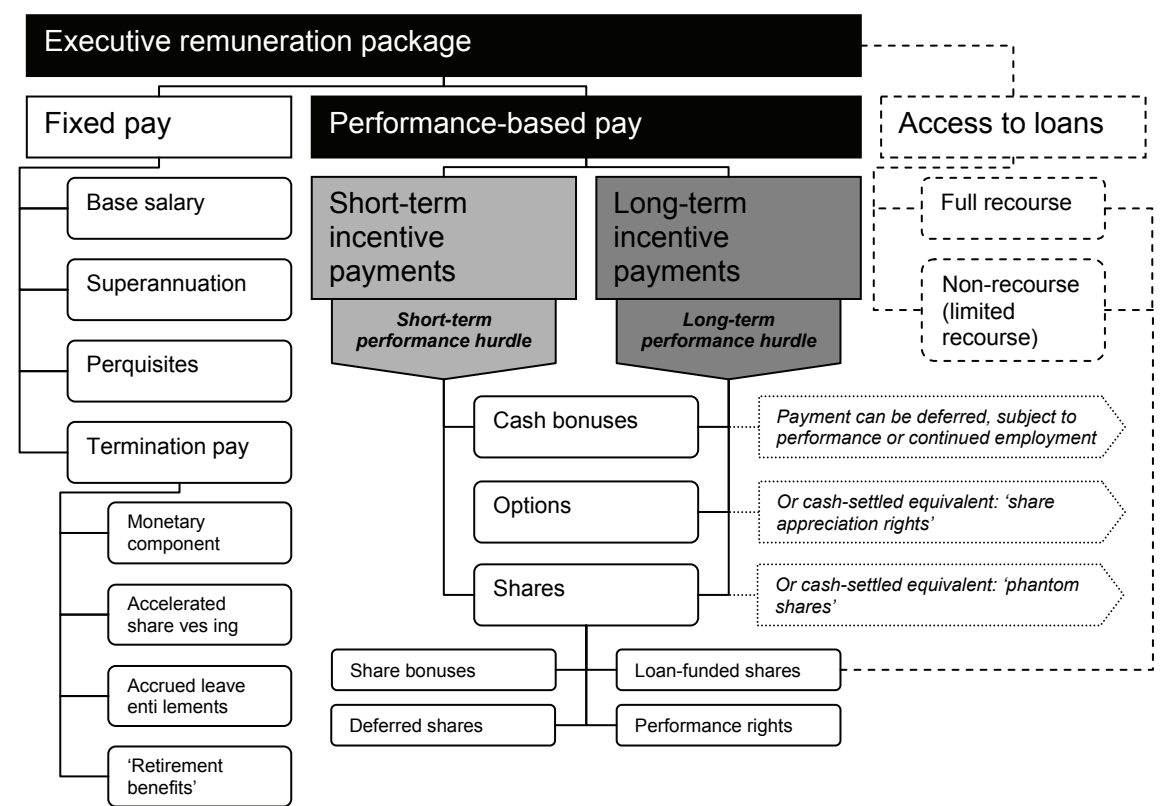
- paying executives shares or options with holding requirements. Equity directly links some of the executive's wealth to the share price (and dividends) of the company.
- awarding remuneration (cash, options or equity) when performance hurdles are met in the short term (generally one year) or long term (around three years). Short-term hurdles often relate to a company's financial performance, OH&S outcomes or business strategy implementation, whereas long-term hurdles usually relate to broader market metrics such as total shareholder return.

'Ideal' remuneration structures vary because risk preferences vary across companies and individuals. Start-up ventures are likely to have a greater risk tolerance than established companies. Some executives prefer greater certainty in remuneration and will be willing to trade off upside rewards for less downside risk.

The various pay forms and hurdles (and combinations of them) have different incentive effects. Options provide more (possibly excessive) 'upside' incentive than shares, but little downside risk. Once 'under water', they provide little incentive to drive an incremental increase in share price. Large equity holdings can promote alignment yet might make executives risk averse (especially as they approach retirement).

- The complexity of some incentive pay arrangements in more recent times (figure 7) could have allowed unanticipated upside (especially during the share market boom prior to 2007-08), yet weakened or distorted the incentive effects for executives.
  - Short-term incentives linked to inappropriate performance metrics in the finance industry in some instances encouraged excessive risk-taking, although they appear to have been far less pervasive in Australia than overseas. Such practices are the focus of the Australian Prudential Regulation Authority's new remuneration guidelines.
  - The Commission understands that executives view some complicated long-term incentives linked to share market performance as akin to a lottery, such that they have little (positive or negative) incentive effect, yet could end up delivering large payments to the executive at large cost to the company.

Figure 7 Executive pay is multi-dimensional



### Strong corporate governance is the key

As noted at the outset, the prime motivation for this inquiry is a widespread perception that executives have been rewarded for failure or simply good luck. And certainly in some periods and for some CEOs, pay outcomes appear inconsistent with a reasonably efficient executive labour market.

While the direct consequences of these for aggregate economic efficiency in the Australian context might not have been large (representing in most cases a profit transfer from shareholders to executives), instances of ‘excessive’ pay tied to perverse incentives could have weakened company performance. Executive remuneration outcomes also provide a window on board performance more broadly, with apparent board ‘failure’ fomenting disquiet among investors and the community more broadly, potentially sapping confidence and trust in equity markets.

Particularly at a time of sharemarket weakness, such disquiet has been fuelled by well-publicised examples of seemingly egregious pay outcomes, and can lead to other companies being tarred with the same brush. This should make all Australian

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companies concerned about good governance and community perceptions of their conduct.

But having examined a number of alternative measures proposed by participants, the Commission is convinced that the way forward is not to bypass the central role and responsibility of boards in remuneration-setting, especially through prescriptive regulatory measures such as mandated pay caps.

- Although they might superficially address concerns about fairness, caps on total remuneration for executives would give rise to a number of severe practical problems, due to variations in market circumstances across companies and over time. They would also disadvantage some firms over others and have undesirable commercial consequences for Australian companies relative to their competitors.
- Caps on bonuses or other elements of pay, or tax arrangements designed to have similar constraining effects, would lead to readjustment of packages in ways that could weaken incentive alignment, but with probable negligible impact on total remuneration levels.

Furthermore, the Commission considers that a binding shareholder vote on the remuneration report would be unworkable given the report's complexity and coverage, and would compromise the board's authority to negotiate with executives. (However, reducing the trigger for termination payments to require shareholder endorsement seems on balance to be warranted, and given evidence that most companies already tie termination payments to around one year's base salary, the new legislated provisions are unlikely to have significant adverse effects, while addressing shareholder and community concerns.)

In seeking to overcome the perceived problem of captured or incompetent boards, such regulatory proposals risk 'throwing the baby out with the bathwater' and making shareholders worse off — the principal-agent 'problem' cannot be eliminated without removing the wealth-creating public company structure that creates it (box 5). The only practicable means for the many thousands of diverse shareholders of a public company to achieve a remuneration structure that promotes the company's long-term interests is for them to ensure that they have an able and properly motivated agent — the board.

Accordingly, the Commission considers that the more appropriate and proportionate response is to improve corporate governance and enhance the effectiveness and credibility of boards, as well as to make boards more accountable in relation to pay setting, taking into account the need to minimise potential costs and the scope for unintended consequences.

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**Box 5      The role of boards and the principal–agent problem**

‘Wide’ or diverse company ownership necessitates separation of ownership from management of the company. Employing skilled, specialist managers can bring large benefits, but there is the potential for them to pursue their own objectives rather than those of the company and its shareholders. This is the principal–agent ‘problem’.

The primary mechanism for ensuring managers act in the company’s (and therefore shareholders’) interests is shareholders electing boards which have the authority for hiring and remunerating the CEO as well as for taking decisions about company strategy and profit distribution. Importantly, company boards have a fiduciary duty to act in the interests of the *company*, not shareholders per se. This distinction is deliberate — promoting the company’s interests will be in the interests of shareholders as a group over time, but is unlikely to be in the best interests of each and every shareholder all of the time. Indeed, if the board were expected to meet every shareholders’ preferences, the benefits of delegating authority to it and, hence, the benefits of the widely-held public company structure, would be largely forfeited.

**Promoting communication and capabilities and minimising conflicts of interest**

Australia’s regulatory framework has been progressively strengthened over time, together with industry corporate governance arrangements, balancing prescription with flexibility. There is scope to further strengthen the framework and achieve a closer alignment between the interests of executives, shareholders and the boards that represent them.

The Commission is recommending a number of reforms aimed at minimising the scope for conflicts of interest in remuneration setting and at strengthening board accountability on remuneration matters generally. Many of these complement reforms proposed by the Australian Prudential Regulation Authority for the financial sector, but with wider application.

Some of the proposals apply more strictly to larger companies than smaller ones, even though corporate governance is much closer to best practice in the former than the latter. But how well larger companies perform affects many in the community. So it is not unreasonable to expect larger companies to meet accepted best practice, while recognising the need for flexibility to accommodate the diversity of Australian companies.

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### *Improving board accountability and capacities*

Boards effectively form a bridge between management and owners. Competent and independent decision making should be their hallmarks and this implies directors having an appropriate mix of skills, knowledge and experience. Yet there are concerns that de facto ‘barriers to entry’ mean that companies are not adequately tapping into, and utilising, available talent for board membership, including women.

While resorting to mechanisms such as strict quotas would risk promoting diversity at the expense of merit and hence company performance, the Commission strongly endorses the ASX Corporate Governance Council proposal for companies to report publicly on progress in achieving their own declared targets. Greater transparency around selection of board candidates regardless of gender should also be encouraged.

An additional measure to ameliorate perceptions of a directors’ ‘club’ would be to give shareholders a say on proposals by the board to limit board vacancies. It seems appropriate that boards that wish to invoke the ‘no vacancy rule’ in relation to the election of directors explain their reasons and seek shareholder approval by way of an ordinary resolution. If that resolution were rejected, vacancies would be declared to the maximum in the company’s constitution for that annual general meeting. The board should still retain the right to appoint a director at any time throughout the year (subject to the usual confirmation at the next annual general meeting) and to fill, or leave vacant, casual vacancies at any time.

### *Avoiding conflicts of interest*

Minimising scope for executives to influence the design of their own remuneration is fundamental to good governance and trust. The Commission accordingly proposes:

- strengthening requirements for the establishment of remuneration committees, the independence of their membership and their interaction with company executives, particularly for the top 300 companies
- requiring remuneration consultants to report directly to the board or remuneration committee (without constraining scope for them to consult with management)
- disclosure in remuneration reports of the use of remuneration consultants.

Further desirable measures would be to exclude executives and directors from voting their own shares or undirected proxies on the remuneration report and related resolutions. While these measures go beyond normal conflict-of-interest voting

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exclusions, the vote on the remuneration report is atypical because it is advisory only, and should aim to capture views on the report of those external to its development.

### *Enhanced disclosure and communication*

The usefulness of remuneration reports to investors has been constrained by their length and complexity, as well as by ‘boiler-plating’ and some crucial omissions. There will always be tension between readability and the desire of investors and advisers for comprehensive reporting, but some changes would improve the balance:

- Plain English presentation would promote investor understanding of executive pay. Company efforts to improve the readability of their reports would be bolstered by guidance on best practice, with boards encouraged to include a discussion of their approach to remuneration setting and the variables and risks considered, as outlined below.
- Reporting of total *actual* pay would be useful to investors (to reconcile with initial estimates and expectations) as would fuller reporting of performance hurdles, taking account of commercial sensitivities. Including a summary of executives’ total equity holdings in the company would also be useful (although this would duplicate material already in the annual report). While shareholdings are not remuneration, they are an important indicator of ‘skin in the game’ and incentive alignment, and thus an important complement to incentive pay arrangements.
- The remuneration report should be confined to ‘key management personnel’, with possible scope to confine detailed reporting to the CEO and other executives on the board (with information being consolidated for other key management personnel).

There also appears to be scope to streamline the architecture of disclosure requirements, with positive payoffs for readability and compliance costs. To this end, the Commission is recommending the establishment of an expert panel under the auspices of the Australian Securities and Investments Commission, to advise it on how best to revise the architecture of section 300A of the *Corporations Act 2001 (Cwlth)* and the relevant regulations to achieve recommended enhancements.

### *Promoting efficient incentive alignment*

While there is no single ‘right’ pay structure for aligning incentives, investors might be reassured if boards have, for example, undertaken prudent risk assessments and

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sensitivity analysis in crafting incentive pay arrangements, as well as considered the scope for simpler and potentially less costly pay structures. The Commission has outlined a ‘checklist’ for good remuneration practice to enhance the information content of companies’ remuneration reports.

Hedging by executives against company-specific risks associated with equity-based remuneration could weaken the intended link between pay and performance in remuneration packages. Although the practice appears uncommon, in line with policies of many companies, hedging of unvested equity and vested equity subject to holding locks should be prohibited.

Furthermore, scope to defer taxation of long-term equity incentives (those at risk of forfeiture) beyond departure could facilitate deferment of remuneration, thereby promoting better alignment of incentives in the latter years of an executive’s term, as well as giving the board scope to ‘claw back’ payments made to executives in the event of unacceptable post-departure outcomes.

### *Encouraging shareholder engagement*

Despite initial scepticism by business, the non-binding vote on the remuneration report appears to have fostered more productive engagement between shareholders and boards. Most boards have proven sensitive to significant minority ‘no’ votes and many amend executive remuneration in anticipation or in response. Yet there are instances where companies have received significant consecutive ‘no’ votes on their remuneration report — in 2008 and 2009 the Commission estimates that almost 5 per cent of ASX200 companies received two consecutive no votes of 25 per cent or more. In addition, the average level of ‘no’ votes has been gradually increasing.

The Commission therefore sees a case for increasing shareholder leverage through the vote on the remuneration report, to target seemingly unresponsive boards in a bid to promote better dialogue between them and their shareholders. But it also recognises that any measures need to be balanced against the desirability of maintaining both the board’s authority to set executive pay, and the integrity and benefits of the non-binding vote itself.

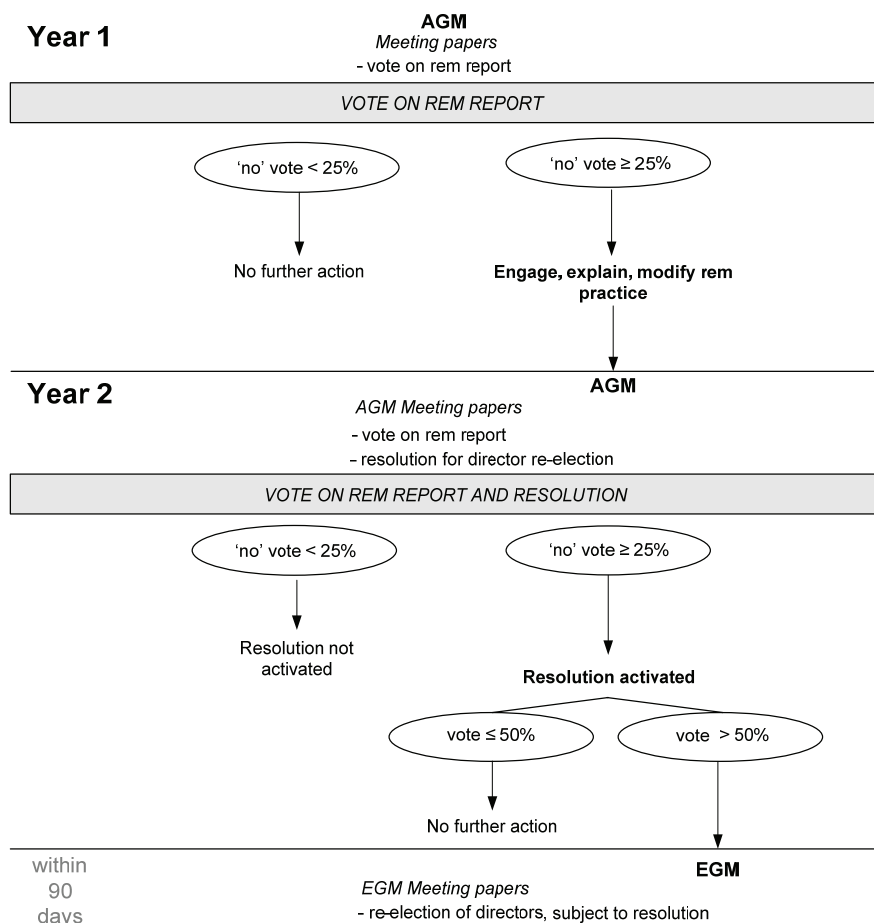
Accordingly, the Commission proposes that:

- Companies be required to explain in the remuneration report their response to a ‘no’ vote of 25 per cent or more the previous year. In essence, this would codify what many companies do voluntarily.

- Where there is a second consecutive vote against the remuneration report of 25 per cent or more, a separate ‘re-election’ resolution would be put automatically at that annual general meeting (and included in voting papers circulated prior to the meeting), to the effect that all elected directors who signed the directors’ report for that year face re-election at an extraordinary general meeting (to be held within 90 days). To pass, this re-election resolution would require a majority of eligible votes cast. (See figure 8)

This approach enables shareholders to voice their opinion on the remuneration report through a non-binding vote and then decide whether stronger action is required by voting on a separate re-election resolution where the board appears unresponsive to their concerns.

**Figure 8 Two-strikes plus a resolution to ‘spill’ the board**



Compared with a mechanism where a second substantial vote against the remuneration report automatically triggered a vote on directors, the insertion of a separate resolution for directors to face re-election would significantly reduce any

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downside risks for the operation of boards and stability of companies, or the willingness of shareholders to vote against a remuneration report. (Typically a high vote against a remuneration report does not translate into a vote against directors standing for re-election.) Yet the mechanism would still hold to account those boards considered deficient in relation to executive pay practices. In short, shareholders would be given control over the message they wished to send to boards, encouraging all boards to maintain a commitment to the development of well-structured pay arrangements.

### *A future review of the reforms*

No intervention is costless or without risk. There will be compliance costs as well as more subtle behavioural consequences. The Commission accordingly ‘stress tested’ its proposed reforms in a Discussion Draft and has made modifications since to take account of a number of valid concerns. Nevertheless, it would be desirable for the Australian Government to conduct a review within five years into the operation, impacts and effectiveness of any reforms flowing from this report, as well as the recently-introduced changes to shareholder approval of termination payments.

### **Summing up**

The Commission considers that, collectively, these changes would significantly strengthen corporate governance and alignment of interests — giving shareholders better information and more ‘say’ on pay.

In doing so, they should reduce the likelihood in future of inappropriate remuneration outcomes, especially those that shareholders would find objectionable, and help secure greater public confidence in the corporate sector. They would not, however, put an end to high pay for executives of the largest companies where warranted to secure the best people and motivate them in line with shareholders’ interests.

Finally, the Commission acknowledges that its proposed reforms may require boards to pay more attention to executive remuneration than some have done in the past. In the Commission’s view, this is called for and will complement rather than compete with other key board responsibilities. Appropriate remuneration structures for executives not only reflect on board competence, but are integral to the successful implementation of corporate strategies and thus the creation of shareholder wealth.

## The recommendations at a glance

<i>Recommendation</i>	<i>Targeted benefits</i>
<b>Board capacities</b>	
1. Any declaration of 'no vacancy' at an AGM to be agreed to by shareholders.	<ul style="list-style-type: none"> <li>Increases shareholder's input on board size and composition and addresses perceptions of a 'directors' club'.</li> </ul>
Finding 1: <i>Support an 'if not, why not' requirement for boards to report progress against gender objectives.</i>	<ul style="list-style-type: none"> <li>Encourages boards to draw more widely from the available talent pool.</li> </ul>
<b>Conflicts of interest</b>	
2. On an 'if not why not' basis: <ul style="list-style-type: none"> <li>remuneration committees to comprise at least three members, all non-executive directors, with a majority and the chair independent</li> <li>companies to have a charter setting out procedures for non-committee members attending meetings.</li> </ul>	<ul style="list-style-type: none"> <li>Constrains executive influence on pay.</li> <li>Promotes best practice for all listed companies.</li> </ul>
3. For ASX300 companies, executives to be prohibited from sitting on remuneration committees. (Listing rule)	<ul style="list-style-type: none"> <li>Constrains executive influence on pay.</li> <li>Aligns with APRA initiative for finance sector and targets companies able to meet compliance cost.</li> </ul>
4. Prohibit executives and directors voting their own shares on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
5. Prohibit executives hedging unvested equity remuneration or vested equity subject to holding locks.	<ul style="list-style-type: none"> <li>Improves alignment between executives and shareholders.</li> <li>Engenders confidence in pay practices.</li> </ul>
6. Prohibit executives and directors voting undirected proxies on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
7. Require proxy holders to cast all their directed proxies on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
<b>Disclosure</b>	
8. Improve information content and accessibility of remuneration reports through: <ul style="list-style-type: none"> <li>a plain English summary of remuneration policies</li> <li>reporting actual remuneration received and total company shareholdings of individuals in the report.</li> <li>Expert panel to advise on revised Corporations Act architecture to support changes.</li> </ul>	<ul style="list-style-type: none"> <li>Better informed shareholders.</li> <li>Reduced confusion (and misreporting) about pay structures.</li> <li>Enhanced engagement between boards and shareholders.</li> </ul>
9. Remuneration disclosures to be confined to key management personnel.	<ul style="list-style-type: none"> <li>Aligns Act with accounting standards.</li> <li>Reduces compliance costs.</li> <li>Improves readability.</li> </ul>

(Continued next page)

## The recommendations at a glance (continued)

<i>Recommendation</i>	<i>Targeted benefits</i>
10. Companies to disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company. ('If not, why not')	<ul style="list-style-type: none"> <li>• Constrains executive influence on pay through transparency.</li> <li>• Promotes best practice for all listed companies.</li> </ul>
11. For ASX300 companies, advisers on executive pay to be commissioned by, and their advice provided directly to, the board, independent of management. (Listing rule)	<ul style="list-style-type: none"> <li>• Constrains executive influence on pay.</li> <li>• Aligns with APRA initiative for finance sector.</li> <li>• Targets companies able to meet costs.</li> </ul>
12. Institutional investors to voluntarily disclose how they have voted on remuneration reports (and other remuneration-related issues).	<ul style="list-style-type: none"> <li>• Better informed (potential) investors.</li> <li>• Targets agency issues, particularly for compulsory superannuation contributors.</li> </ul>
<b>Remuneration principles</b>	
13. Remove cessation of employment as the taxation point for deferred equity subject to risk of forfeiture.	<ul style="list-style-type: none"> <li>• Removes barrier to deferred remuneration.</li> <li>• Consistent with longer term alignment.</li> <li>• Removes need for special tax rulings.</li> </ul>
Finding 2: Remuneration 'check list' for boards to improve information content in remuneration reports.	<ul style="list-style-type: none"> <li>• Enhanced quality of disclosure.</li> <li>• Provides guidance to encourage and promote better remuneration practices.</li> </ul>
<b>Shareholder engagement</b>	
14. Confirm allowance of electronic voting without amendment of company constitutions.	<ul style="list-style-type: none"> <li>• Improves efficiency and integrity of shareholder voting.</li> <li>• Potential for cost savings.</li> </ul>
15. 'Two strikes and re-election resolution': <ul style="list-style-type: none"> <li>• 25 per cent 'no' vote on remuneration report triggers reporting obligation on how concerns addressed</li> <li>• subsequent 'no' vote of 25 per cent activates a resolution for elected directors to submit for re-election within 90 days.</li> </ul>	<ul style="list-style-type: none"> <li>• Increases shareholder signalling and power.</li> <li>• Increases pressure on companies to respond to shareholder concerns.</li> <li>• Targets unresponsive boards.</li> </ul>
<b>Implementation issues</b>	
16. The Australian Government to implement intent of recommendations 2, 3, 10 and 11 by legislation if the ASX and Corporate Governance Council do not make requisite changes.	<ul style="list-style-type: none"> <li>• Ensures potential benefits from recommended reforms can be achieved.</li> </ul>
17. Review within five years to consider: <ul style="list-style-type: none"> <li>• the effectiveness and efficiency of the reforms, including to termination payments and employee share schemes</li> <li>• the regulatory architecture.</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluation of efficacy and economic impact of reforms.</li> <li>• Identification of any unexpected outcomes that warrant corrective action.</li> </ul>