
7 Linking pay to performance

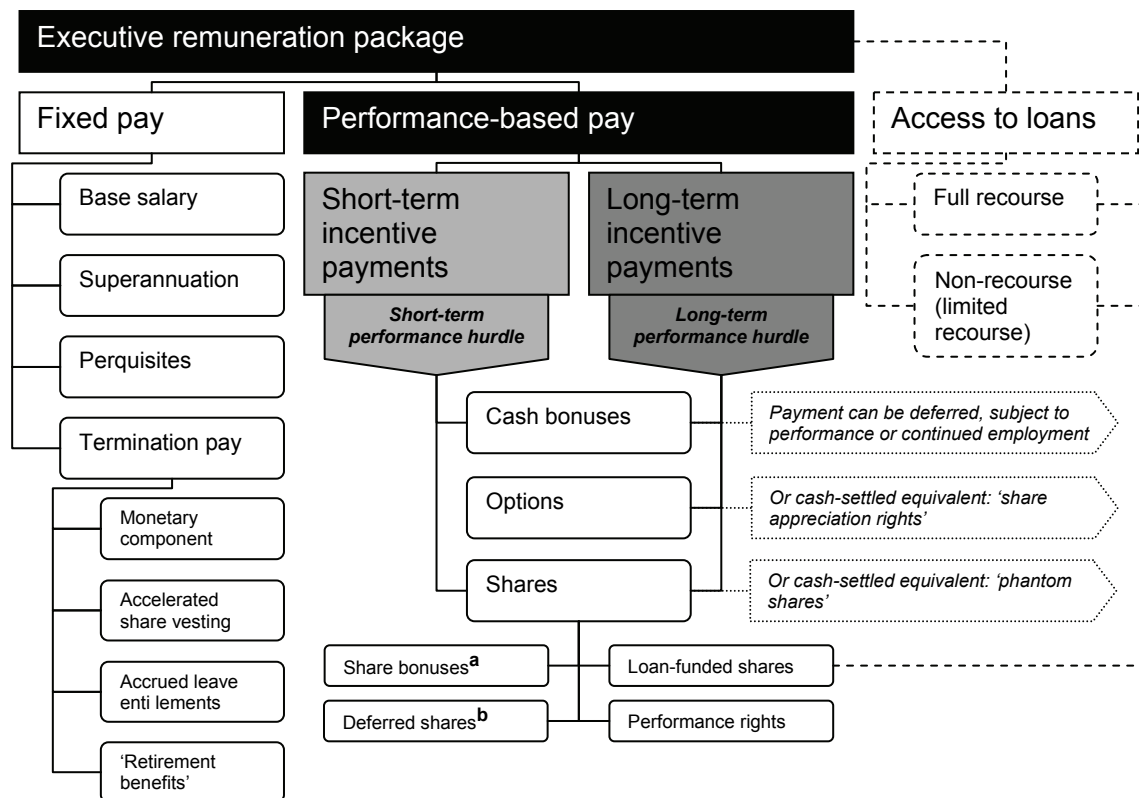
Key points

- Executive performance influences company performance and shareholder value. Different pay instruments and structures can be used to motivate executives to perform in line with the interests of the companies they work for and their shareholders.
- Two key ways that boards link executive remuneration to company performance are by:
 - paying executives in equity, with different instruments presenting different incentive effects and risks
 - using incentive payments based on performance hurdles that relate to company performance. Short-term hurdles can be effective drivers of executive performance when related to appropriate targets, although long-term hurdles are generally more transparent.
- Increased complexity in remuneration structures has responded to the requirements of boards, in the perceived interests of shareholders. In some cases, it is unclear whether this has resulted in company performance outcomes that could not have been achieved by simpler alternatives.
- Non-recourse loans do not appear to be common in Australia. While posing potential problems, such loans could be an effective instrument for some companies (and their shareholders) to align interests, although transparency about their use is required.
- Hedging by executives against company-specific risks associated with equity-based remuneration weakens the intended link between pay and performance.
- Some recent instances of very large termination payments are difficult to justify. Reforms introduced in 2009 will reduce the size of such payments, although, on average, current practice is broadly in line with the new requirements.
- Given the diversity of companies and executives, there is no single 'right' answer to structuring pay. Board discretion remains central to ensuring that pay structures are appropriate for each company's circumstances over time.

7.1 Enhancing performance-based pay

The terms of reference for this inquiry request that the Commission consider the relationship between remuneration and corporate performance. As chapters 3 and 4 have identified, this relationship is multifaceted, with remuneration levels linked to managerial effort, job size and complexity. Complicating this is the indistinct nature of ‘performance’: executive versus company performance, financial versus non-financial performance, and short- versus long-term performance. As a consequence of the diverse interpretations of ‘performance’, the term commonly assumes a form synonymous with the concept of ‘alignment’ — how boards structure executive remuneration to promote the interests of shareholders. (That said, ‘alignment’ presents its own challenges, given the heterogeneous nature of shareholders.) Incentive compatibility is commonly achieved through the adoption of various pay instruments linked to different performance metrics (figure 7.1).

Figure 7.1 Forms of executive pay



^a Shares may be granted as part of a long-term incentive payment without conditions attached. These 'free' shares, however, are uncommon (table 7.1). ^b Also known as 'restricted stock'.

Why link pay to performance?

Without performance-based pay mechanisms, executives would still have incentives to act in the best interests of shareholders (chapter 2), including through ‘reputational concerns, competitive labour markets, and the threat of takeover, dismissal or bankruptcy’ (Aggarwal and Samwick 1999, p. 66). Like other people with responsibilities, most executives will also have their own professional and personal standards, and may feel bound to act ethically and professionally. Regulation can also have some effect (box 7.1).

But these factors might not ensure adequate alignment of incentives. For example, executives might exert less effort than shareholders would like or consume more perquisites (‘perks’) than agreed (Jensen and Meckling 1976; Fama 1980). Executives might also have incentives to undertake inefficient ‘pet’ projects that do not maximise company value.

Boards monitor the effort and decision-making of executives, but it is infeasible for them to scrutinise every action and decision. Performance-based pay can therefore be an efficient means of reducing transaction costs in aligning the risk profiles of

Box 7.1 Regulation and the link between pay and performance

Generally, corporate law and other regulations do not directly mandate a link between pay and performance or specify how it should occur. However, there are some areas where regulation is involved.

Australian Securities Exchange listing rules 10.17 and 10.17.2 specifically exclude directors (either executive or non-executive) of publicly-listed companies from being paid by way of commission on, or as a percentage of, operating revenue.

Section 588FDA of the *Corporations Act 2001* (Cwlth) permits the recovery of payments made to the directors of a company that enters insolvency (where it is judged that a ‘reasonable person’ would not make such a payment). While initially proposed as a mechanism for clawing back bonuses to executive directors, the Act is ‘deliberately broad and would include (without limitation) base salary payments, options or any other form of accommodation provided to or for the benefit of a director which is deemed by the Court to be excessive’ (Launders and Edwards 2002). Payments made up to four years before a company’s collapse are potentially recoverable. However, section 588FDA does not apply to payments made to executives who do not serve on the board. Moreover, perceptions of a ‘reward for failure’ will not always be addressed by the legislation. Bonuses may be paid to the chief executive officer of a company that suffers a decline in share price, but if it avoids bankruptcy, then the *Corporations Act* does not allow for any ‘unreasonable’ payments to be recovered.

Disclosure requirements for the remuneration report also include discussion on remuneration policy and its links to company performance (chapter 8).

executives with those of the companies that employ them (box 7.2). Although no mechanism will ever be able to achieve a *perfect* alignment of interests, *improved* alignment can be attained at a lower cost than monitoring. Moreover, given that each company's circumstances differ (and generally change over time), alignment will require a range of approaches across the market, as different pay instruments deliver different incentive effects.

In light of this diversity, the structure of incentive schemes is critical. Incentives intended to achieve a particular outcome could have potentially harmful unintended consequences if inadequately designed. For example, if a manufacturing executive were to receive performance pay based only on cost reductions, he or she might have a perverse incentive to reduce the company's output.

Boards attempt to link executive remuneration to the interests of shareholders by:

- paying executives in shares or options and requiring executives to hold this equity for a period of time. This directly links some of the executive's wealth to the share price and dividends of the company — a key concern for shareholders
- using incentive payments that award additional remuneration based on whether performance hurdles are met. These payments (and hurdles) can be short term or long term. The extent to which remuneration is linked to company performance depends on the performance hurdle used and the threshold for payment.

For larger companies, most executive remuneration structures include a mix of cash and equity-based payments, and also short- and long-term incentive payments (see

Box 7.2 Structuring remuneration packages to align risk profiles

Executives and the companies that employ them are all different, so remuneration structures will need to vary.

A key consideration is the relative risk profiles of companies and executives. In the standard case, businesses are risk neutral, whereas their employees tend to be risk averse (Eisenhardt 1989). (The reason being that companies are likely to have a wide range of costs, of which employing workers is just one. By contrast, employees are likely to be highly dependent on their employment as a major — and potentially sole — source of income.) As such, companies will either absorb a greater portion of risk than their employees (that is, pay the employees irrespective of performance) or will need to compensate employees more for accepting risk (a 'risk premium').

In practice, risk profiles across companies and executives will vary. Startup ventures are likely to have a much greater risk tolerance than more established companies, for example. Some executives might prefer greater certainty in remuneration and be willing to trade off potential upside benefits for less downside risk (for example, a greater proportion of fixed pay).

below). Not all payments are directly linked to ‘performance’ — the key example being base salary (at least while the executive retains his or her position). On average, base salary comprises between one third and one half of a chief executive officer’s (CEO’s) remuneration (chapter 3). Of course, if an executive received only fixed pay, it is unlikely that he/she would fail to perform. However, performance-based pay can provide incentives for higher levels of performance.

Different forms of incentive-based remuneration present different levels of risk and uncertainty for which the executive will need to be compensated (box 7.3). This is further complicated by a divergence between the costs to companies and the value to executives from executive remuneration (box 7.4).

Equity-based payments

Equity-based payments directly link some of an executive’s wealth to the share price (and dividends) of the company, which can be a good proxy for shareholder interests. Although paying in equity can, in principle, be straightforward, in practice, such payments tend to introduce complexity into executive remuneration arrangements, posing challenges for valuation (appendix E). Such complexity can also arise from the array of different payment instruments available.

While the most common forms of equity-based remuneration are shares and ‘options’ (which offer recipients the right to buy shares at a pre-agreed ‘exercise’ price), they are seldom granted in Australia without any conditions attached (table 7.1). Performance rights are a type of share grant conditional on performance hurdles being met, while deferred (or ‘restricted’) shares are conditional on an executive remaining employed by the company for a specified period of time. Other types of share grants can incorporate a combination of these attributes. (Performance rights and deferred shares have been described as ‘zero exercise price options’ — giving executives the right, subject to meeting specified conditions, to obtain shares at a pre-agreed price (nil). However, in this chapter, references to stock options do not include these forms of equity-based payment.)

More exotic forms of remuneration also exist. For example, ‘share appreciation rights’ pay executives in cash the value of any share price rises — in effect mimicking the payout from an option, but without the executive ever holding the security itself. Given their structure, the incentive effects associated with such cash-based arrangements are likely to be equivalent in most respects to their equity-settled counterparts. Such forms are not explicitly discussed in this report, but it is worth noting that different forms of remuneration have emerged in response to policy changes to constrain or tax the use of particular instruments.

Box 7.3 Linking pay to performance is not costless: a stylised example

Employees generally prefer certainty to uncertainty in their income. This stylised example illustrates that the greater the risk in remuneration faced by executives, the more the 'headline' remuneration amount will need to be to compensate for that risk.

Two executives, Jack and Jill, each have a reservation wage of \$600 000 — the minimum amount they would require in cash today for them to be willing to perform the role. However, given the preference of boards and shareholders to align an executive's interests with those of the company, boards might consider different techniques for linking pay to performance. These include: deferring payment, linking payment to the achievement of performance hurdles, and paying in equity. While each of these can potentially improve incentive alignment, they will also be discounted by executives (in potentially different ways), thus affecting the total amount to be paid:

- The value of a dollar today is not the same as a dollar tomorrow. Jack applies a discount rate of 8 per cent, while Jill assumes 5 per cent. To achieve the same value as \$1 in cash today, Jack will need to be paid at least \$1.08 for deferral of one year; Jill, at least \$1.05.
- Performance-contingent payments are, by design, not certain outcomes. Even if executives are confident about their abilities, they are not exclusively responsible for companies' performance. Jack assumes that his probability of meeting the hurdle is 50 per cent. Jill believes her hurdle is more attainable, and assumes a probability of achievement of 80 per cent. To achieve the same value as \$1 in cash today, Jack will need to be paid \$2 for any amount subject to the hurdle; Jill, \$1.25.
- Equity is also less certain than cash, as share prices change over time. The company Jack will work for has share price volatility of 20 per cent over the relevant timeframe, meaning that the minimum outcome is expected to be 80 per cent of the current value. Hence to achieve the same value as \$1 in cash today, Jack will need to be paid \$1.25 in equity. By contrast, Jill's company has share price volatility of approximately 11 per cent, so she will need to be paid \$1.12 in equity.

In this illustrative example, the \$600 000 is split equally between cash, deferred cash, performance-contingent cash, equity, deferred equity and performance-contingent equity. For simplicity, tax is excluded and vesting occurs over one year.

From \$600 000 'in the hand' to...

	<i>Jack</i>	<i>Jill</i>
Cash	\$100 000	\$100 000
Deferred	$\$100\,000 \times 1.08 = \$108\,000$	$\$100\,000 \times 1.05 = \$105\,000$
Performance	$\$100\,000 \times 1.08 \times 2 = \$216\,000$	$\$100\,000 \times 1.05 \times 1.25 = \$131\,250$
Equity	$\$100\,000 \times 1.25 = \$125\,000$	$\$100\,000 \times 1.12 = \$112\,000$
Deferred	$\$100\,000 \times 1.25 \times 1.08 = \$135\,000$	$\$100\,000 \times 1.12 \times 1.05 = \$117\,600$
Performance	$\$100\,000 \times 1.25 \times 1.08 \times 2 = \$270\,000$	$\$100\,000 \times 1.12 \times 1.05 \times 1.25 = \$147\,000$
Total future pay offered to achieve certainty-equivalent wage of \$600 000 =	\$954 000	\$712 850

Box 7.4 The cost to the company versus the value to the executive

Discussions around remuneration generally consider the cost faced by companies (and, by extension, shareholders) in employing executives. But another relevant factor is how executives themselves value the different components of their remuneration, as this influences the effectiveness of performance incentives.

The divergence between cost (to the company) and value (to the executive) can stem from the properties of different pay instruments. For example, a cash payment made today will probably be worth much the same to an executive as its cost to the company. But equity-based remuneration is likely to be different. In the case of granting shares acquired on market, the company faces a one-off cost (buying the shares), while the executive faces not only the initial benefit of remuneration (the shares as income), but also the changes in the share price over time (the shares as wealth, affected by capital gains and losses).

As box 7.3 suggests, deferred payments and the application of performance hurdles can have similar effects. Additional factors that can contribute to a divergence between cost and value are portfolio risk (that is, the relative concentration of an executive's wealth in the company's stock) and transaction costs (faced by boards in monitoring executive performance and designing 'optimal' incentive pay structures).

Table 7.1 **Equity-based payments: extent of use, 2002-03 to 2007-08**

Remuneration of CEOs at ASX100 companies

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Options	%	%	%	%	%	%
Proportion of CEOs	46	51	43	39	54	49
Proportion of total remuneration ^a	11	8	7	6	9	11
Performance rights						
Proportion of CEOs	19	28	29	39	30	54
Proportion of total remuneration ^a	4	4	6	8	9	12
Deferred shares						
Proportion of CEOs	13	21	28	24	23	11
Proportion of total remuneration ^a	3	3	6	4	6	2
Loan-funded shares^b						
Proportion of CEOs	12	8	9	11	6	9
Proportion of total remuneration ^a	1	–	1	2	–	1
'Free' shares^c						
Proportion of CEOs	–	1	3	–	1	3
Proportion of total remuneration ^a	–	–	–	–	–	–

^a Based on reported values disclosed in remuneration reports, not pay actually realised. See chapter 3. ^b May be offered on 'non-recourse' or 'full recourse' terms. See section 7.2. ^c Shares granted without condition as a long-term incentive payment. – Nil or rounded to zero.

Source: ACSI (2009d).

Options versus actual shares

Different types of equity-based payment can have different incentive effects (table 7.2). One instrument that has become particularly contentious is options. (Appendix E discusses the mechanics of options values more extensively.)

Remuneration in options can magnify the returns to executives (and costs to companies) of share price rises between grant and exercise, compared to remuneration in shares. Since options are valued at less than the value of the underlying shares, \$1000 remuneration in options will give the executive access to more shares than if he or she simply received \$1000 in shares. However, if the share price fell below the exercise price between the grant date and expiration (the options are ‘underwater’), the executive would receive no equity, even if performance hurdles were met. By contrast, shares will generally retain some value.

Some concerns relate to the lack of a consistent technique for valuing options for disclosure purposes, which may reduce transparency and, in particular, obscure from shareholders how much executives are actually being paid (chapter 8). Concerns also stem from US accounting scandals in the early 2000s, including the collapse of Enron. Some argued that senior executives at that company were focused on driving the share price to unsustainably high levels in the short term in

Table 7.2 Upside, downside
The incentive effects of different forms of pay

	<i>If share price rises</i>	<i>If share price falls</i>
Cash	<ul style="list-style-type: none"> • No direct benefit from improved company performance 	<ul style="list-style-type: none"> • No cost — insulated against downside risk
Shares	<ul style="list-style-type: none"> • Executive enjoys full benefit of share price increases • Incentive to improve company performance to increase value of shares and dividends • As executive prepares to depart the company, may have incentive to reduce share price volatility by taking less risky decisions (which might not maximise company performance) 	<ul style="list-style-type: none"> • Executive’s wealth progressively eroded as share price falls • Incentive to improve company performance to increase value of shares and dividends • As executive prepares to depart the company, may have incentive to reduce share price volatility by taking less risky decisions (which might not maximise company performance)
Options	<ul style="list-style-type: none"> • Upside magnified — executive gains full benefit of any share price increases above the exercise price • Incentive to improve company performance to increase value of options 	<ul style="list-style-type: none"> • Intrinsic value of options is nil when share price is less than exercise price • Incentive to avoid share price falling below exercise price • However, where share price falls significantly below exercise price, weak incentive to try and improve company performance

order to realise value from stock options (Samuelson 2002). Rather than strengthening the alignment of executives' interests with those of shareholders, options (in that scenario) created a divergence between the two.

However, options are not *inherently* poor instruments for remuneration. But they are likely to have been poorly structured in some instances, leading to detrimental outcomes. Options will be better suited to companies in specific circumstances, with size and stage of development likely to be important factors. For example, the Australian Institute of Company Directors (AICD) suggested:

The level and form of executive remuneration packages decided upon is also influenced or constrained by the company's working capital position. For example, a greater emphasis on equity-based arrangements (e.g. options) as opposed to cash is often evident for smaller companies, particularly start-ups. It is important to recognise that there are approximately 2000 ASX-listed companies and the vast majority of these are [small or medium enterprises]. (sub. 59, pp. 24–5)

Importantly, new ventures are likely to be riskier than established businesses and will want to attract suitable executive talent to maximise their chances of success. However, startups are also likely to be cash constrained, making options an attractive instrument: they minimise the initial cash outlay for the company, while offering the executive a potentially high payoff if the company performs well.

Just as options magnify the upside potential relative to a grant of shares, their incentive effects on the downside are also quite different. For an option, once the share price falls below the exercise price, it has no intrinsic value. Hence, further declines in the share price do not affect the executive's wealth. Where the share price falls significantly below an option's exercise price and is not expected to exceed the exercise price before the option expires, the performance incentive virtually disappears. In these circumstances, the executive receives no benefit from generating a modest improvement in the company's performance.

In the case of shares, however, the executive's wealth is progressively eroded the further the share price falls. The worse the company performs, the more the executive loses. Furthermore, any improvement in the share price translates into a benefit to the executive. Hence, the executive still retains a strong interest in improving the company's performance even after a significant decline in value.

Share grants are unlikely to be as useful for new ventures, which by definition start off with little value, but have much upside potential. By contrast, 'mature' companies will have greater concern about the incentive effects when share prices fall. A stronger, although not perfect, alignment of interests between executives and shareholders may be achieved where the executive faces the same effect as shareholders from persistent share price declines.

Thus, there is not a simple answer to the question of what the ‘right’ equity-based instrument is. A remuneration structure that works well at one company might prove disastrous at another. And what works well for an individual company at one point in time might not at another. Choosing the best equity-based instrument/s therefore requires careful consideration of the company’s circumstances. Simply following market trends might be unhelpful if boards (or, indeed, shareholders) do not fully understand the implications of using increasingly sophisticated forms of pay.

Equity-based payments to non-executive directors

Incentive schemes for executives are predicated on the basis that they align management’s interests with those of the company and shareholders. A similar argument applies to non-executive directors (NEDs). CGI Glass Lewis argued:

Corporate governance best practice dictates, and shareholders believe, that NEDs should acquire and maintain meaningful shareholdings in the company to align their interests and risk profile with the interests and risk profiles of shareholders. Shareholders believe, and common sense supports that belief, that having ‘real skin in the game’ will operate on the hip pocket of the NED, which aligns with the hip pocket of shareholders, and thereby apply the most effective focus for the NED’s fiduciary duty to act in the best interest of the company and its shareholders overall. (2009, p. 4)

The important role of NEDs in monitoring executives nevertheless presents the potential for conflicts of interest. If NEDs were remunerated in the same way as executives, then the independence of the board (particularly on remuneration matters) could be undermined, with the decisions they make with regard to executive pay having an impact on their own earnings. In addition, setting performance hurdles for non-executives would be illogical, since the board does not have any day-to-day responsibilities for managing the company. Indeed, performance-based payments to NEDs could be dangerous, if they encouraged boards to endorse investments and strategies that might deliver short-term gains, but were not prudent over a longer timeframe.

For these reasons, performance-related pay for NEDs is generally advised against. For instance, the Australian Council of Super Investors (ACSI) states that independent NEDs should ‘not participate in any ... performance-related remuneration schemes that apply to executives within the company’ (2009a, p. 10). Recommendation 8.2 of the ASX Corporate Governance Council (2007a) principles and recommendations stipulates that the structure of NEDs’ remuneration should be clearly distinguished from executives’ remuneration. The situation is similar in Europe, with stock options identified as inappropriate for NEDs (box 7.5).

Box 7.5 Remuneration of NEDs: international experience

The UK Combined Code stipulates that remuneration of NEDs should not include share options. If options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the NED leaves the board (FRC 2008).

The European Commission (2009a) has recommended that NEDs not be paid with share options.

- In the Netherlands, NED remuneration is agreed to by shareholders. (In practice the NEDs will themselves draw up a proposal for remuneration packages, which is then submitted to the company's general meeting of shareholders for approval.)
- Both Belgium and Germany specify in their governance codes that the remuneration of NEDs should take into account their role as ordinary board members, and their specific roles, as chair of the board, chair or member of board committees, as well as their resulting responsibilities and time commitments. However, in Belgium the code specifically stipulates that NEDs should not be entitled to performance-related remuneration such as bonuses, share-based long-term incentive schemes, fringe benefits or pension benefits.
- In Denmark, Danish courts have ruled that board members must receive equal payment, unless higher pay is justified due to workload (for example the chair of the board is generally paid considerably more than other board members). The Danish Committee on Corporate Governance has proposed that NEDs should not be granted stock options (ECGI 2008).

Australian Securities Exchange (ASX) listing rule 10.17.2 mandates that NEDs of publicly-listed companies be remunerated only by way of a fixed sum, either as cash or shares. For example, the Investment and Financial Services Association states:

Non-executive directors should acquire equity participation independently and from their own resources. In particular, non-executive directors should not participate in a share or option scheme designed for the executives whose role is to manage the company on a daily basis. The non-executive directors' role is to assess effectively the performance of the company and its executives, and a conflict of interest would be created if directors participated in a similar scheme to the executives. (2009, p. 24)

Many companies have established share schemes for NEDs, allowing (or even requiring) them to 'salary' sacrifice some portion of their directors' fee for the purpose of buying equity. While few inquiry participants commented specifically on such arrangements, those who did tended to view them favourably (for example, PricewaterhouseCoopers, sub. 85, p. 5).

Fee sacrifice schemes facilitate NEDs' ownership of equity in the companies they serve (the 'skin in the game' factor), while remaining separate from the incentive schemes provided to executives. As such, fee sacrifice schemes help to mitigate potential conflicts of interest, while still retaining an appropriate alignment of interests between NEDs and the company.

Performance hurdles

A common way of encouraging executives to act in the best interests of the company over time is the use of payments (either in cash or equity) linked to performance hurdles. Companies typically apply separate hurdles for short-term and long-term incentive payments.

Although not contained in a formal recommendation, the ASX Corporate Governance Council (2007a) advocates the use of performance hurdles in executive remuneration packages. In particular, it supports *relative* performance measures — generally 'relative total shareholder return' (relative TSR). Under this metric, the company's performance (measured in terms of share price movements, accounting for dividend payments) is benchmarked against either a specific group of peers or the broader sharemarket index, in order to strip out the effect of sector-specific or general market movements.

Data from Hay Group reveal that, in recent years, long-term incentive payments have commonly been subject to a performance measurement based on relative TSR (table 7.3). Long-term performance hurdles can also include accounting measures, such as earnings per share (EPS) (box 7.6).

Short-term incentives may also adopt financial hurdles. However, these tend to operate in conjunction with hurdles that emphasise an executive's individual performance or internal key performance indicators. ACSI observes:

[Short-term incentive plans] usually have performance indicators relating to: (a) 'quantitative' metrics such as company-wide accounting performance (such as earnings before interest, depreciation, tax and amortisation), business-division performance, successful completion of major projects, etc; and (b) 'qualitative' metrics such as customer or employee satisfaction. An increasing trend has been for companies to also include measures relating to sustainability (such as occupational health and safety) in annual bonus programs ... (2008c, p. 2)

Box 7.6 Measuring long-term performance

Assessing a company's performance is critical for shareholders in making investment decisions. Yet there is tremendous diversity amongst the ranks of shareholders and the companies they invest in. The metrics that are used to assess company performance can take many different forms. These affect the nature of the hurdles that are used for options, performance rights and other equity-based payments.

Total shareholder return

TSR is related to a company's share price performance, adjusted for the effect of dividend payments. (Although some companies still use the share price as a performance metric, the share price is susceptible to manipulation through such factors as the payment of dividends. TSR, by contrast, avoids this problem.) However, TSR performance may be inflated by general sharemarket rises (or depressed by market falls), resulting in executives being rewarded (or penalised) for factors over which they have no influence.

Consequently, many companies have chosen to measure TSR performance relative to a group of peers. These may be specific competitors (either domestic or global), an industry-specific index, or the broader sharemarket. Relative TSR is able to strip out the effect of sectoral or market-wide trends. However, the effectiveness of hurdles relying on this metric will depend largely on the appropriateness of the peer group. Companies might not always have strong comparators (KPMG, sub. 95). Additionally, some shareholders might be concerned by payments made to executives on the basis of relative TSR if a company's performance is weak in absolute terms, but simply not as poor as the chosen peer group's performance (Australian Shareholders' Association, sub. 54, p. 19). Certainly if a company outperforms its peers in a tough environment, it seems reasonable for its executives to be rewarded. It is possible that, with a different executive team in place, the company would have performed worse. However, if the peer group is inappropriately selected, this could lower the absolute performance level required to meet the hurdle.

Accounting measures of performance

While measures of performance based on the sharemarket are particularly common in setting hurdles, some companies adopt accounting-based measures. There are a number of metrics in this area, most prominently EPS, but also return on equity, net profit after tax and earnings before interest, tax, depreciation and amortisation.

Like TSR, accounting metrics tend to be observable by those outside the company. WorleyParsons says EPS growth is a useful metric, as it 'provides a clear line of sight between executive performance and Company performance' (2008, p. 23). Macquarie Group adopts return on ordinary equity (relative to a peer group) as a measure of performance because it is 'correlated over time with total shareholder returns' and because it is an area in which the executive can exercise 'considerable control' (2008, p. 74).

(Continued next page)

Box 7.6 (continued)

Some participants expressed concern about accounting hurdles as being too easy to manipulate. For instance, Stern Stewart and Co. argued:

... accounting measures of performance are ... notoriously subjective. Be it rates of depreciation or amortisation, mark to market valuations, fair value adjustments — the list goes on — [chief financial officers] are able to swing the reported result in a way that can be material to their bonus, while staying within the definition of profit provided by the accounting standards. (sub. 53, p. 6)

Nevertheless, accounting-based hurdles are supported by both the ASA (sub. 54) and ACSI (sub. 71), where used in conjunction with a hurdle based on shareholder value (such as relative TSR). However, ACSI would not generally support performance rights granted solely on the basis of an absolute accounting-based hurdle.

Risk-adjusted measures of performance

Efforts to align the interests of executives with those of shareholders have become more complex over time, with new performance metrics proposed for different purposes. One example is 'economic profit' (also known as 'economic value added' or 'risk-adjusted return on capital'), which adjusts company profits for capital costs.

While currently uncommon, economic profit might be adopted more frequently, particularly in the financial sector, given its implications for risk. (The Australian Prudential Regulation Authority has recommended that banks and insurers take greater account of risk in remuneration practices. See box 5.4 in chapter 5.) As riskier businesses tend to face higher capital costs, executives will have an incentive to avoid 'excessive' risk-taking.

However, such an approach does face practical constraints. As the Australian Bankers' Association observed, economic profit does not completely account for share price changes (and thus obscures the link to creating shareholder value) and is difficult to estimate (sub. 70, p. 25). CGI Glass Lewis and Guerdon Associates suggest that economic profit is 'complex and difficult to understand, expensive to administer, requires discretionary judgment, difficult to audit for fair assessment, and not well suited to less capital intensive companies' (sub. 80, p. 28).

Non-market measures of performance

Some companies base long-term performance hurdles on the achievement of specific targets or completion of specific milestones. For example, the Commonwealth Bank (2008) partially links long-term incentive payments to improvements in the bank's customer satisfaction rankings. This can be a useful approach if the goals are effectively aligned with long-term performance. However, shareholders might have concerns about the transparency of such metrics, particularly where they are linked to internal performance indicators that cannot be objectively verified. Problems could also emerge if the emphasis of certain objectives causes executives to address those areas at the expense of others. Such a distortion would have the potential to impair long-term company performance.

Table 7.3 Performance hurdles over time: extent of use, 2000-01 to 2006-07^a

Hay Group sample of ASX-listed, overseas-listed and unlisted companies^b

	2001 ^c	2002 ^c	2003 ^c	2004	2005	2006	2007
Options	%	%	%	%	%	%	%
Relative EPS	} 73 ^d	} 74 ^d	} 90 ^d	0	0	0	0
Absolute EPS				5	13	13	14
Relative TSR				63	61	57	62
Absolute TSR				0	9	9	10
Time-tested only	27	26	10	26	22	35	29
Other			– ^e	11	9	9	5
Other equity							
Relative EPS			} 54 ^c	8	3	0	0
Absolute EPS				4	8	7	11
Relative TSR				80	75	79	73
Absolute TSR				0	8	7	7
Time-tested only	90–100 ^f	90–100 ^f	46	8	8	19	16
Other			– ^e	16	14	10	8

^a Proportions will not always sum to 100 per cent as companies may adopt more than one hurdle for incentive schemes. ^b Nearly half of the Hay Group sample comprises non ASX-listed entities. Of ASX-listed entities surveyed in 2008, the majority were ranked within the top 50 companies by market capitalisation, although the sample's reach extended beyond the top 300. ^c Data reported for 2001–03 based on qualitative descriptions. ^d 'Almost all' hurdles based on relative TSR. However, two companies reported having an EPS hurdle linked to inflation (although whether this is for options or for other types of equity is not specified). ^e Two companies base hurdles on share price growth (although whether this is for options or for other types of equity is not specified). ^f Only a 'small number of [other equity] plans have performance criteria' (that is, EPS or TSR hurdles). This implies virtually all 'other equity' incentive plans are deferred share schemes rather than performance rights. – Nil or rounded to zero.

Source: Hay Group (2009).

How are performance hurdles used?

To identify how performance hurdles are used, the Commission analysed the short-term and long-term incentive payment performance hurdles presented in the remuneration reports of the top 20 ASX-listed companies by market capitalisation, along with a further 10 companies randomly selected from the ASX100 index (excluding the top 20).

A summary of short-term hurdles is presented in tables 7.4 and 7.5, while long-term hurdles are presented in tables 7.6 and 7.7. Further details from remuneration reports in 2009 are contained in box 7.7.

Table 7.4 Short-term performance hurdles for top 20 companies^a

Company	Performance hurdles				Form of payment
	Non-financial hurdles	Financial hurdles	Specify relative weighting? ^b	Specify level performance for payment?	
BHP Billiton	✓	✓	✗	✗	Cash and deferred shares/options
Rio Tinto	✓	✓	✗	Part ^c	Senior execs: 100% deferred shares Other execs: 50% cash and 50% deferred shares
Commonwealth Bank	✓	✓	✗	✗	67% cash and 33% deferred shares
Woodside	✓	✓	✗	✗	67% cash and 33% deferred shares ^d
Telstra	✓	✓	50:50	✗	CEO: 50% cash and 50% deferred shares Other execs: 75% cash and 25% deferred shares
National Australia Bank	✓	✓	✗	✗	Primarily deferred shares ^e
Westpac	✓	✓	✗	✗	CEO: 60% cash ^e and 40% deferred shares Other execs: 75% cash ^e and 25% deferred shares
ANZ	✓	✓	✗	✗	50% cash, 50% deferred shares/options ^e
Fortescue Metals ^f	✓	✓	✗	✗	Cash, deferred shares and/or superannuation
Westfield	✓	✓	✗	✗	Cash ^d
Woolworths	✓	✓	30:70	✗	Cash
Wesfarmers	✓	✓	30–50:70–50	✗	Cash ^g
QBE Insurance	✓	✓	✗	✗	Cash ^h
CSL	✓	✓	✗	✗	Cash
St. George Bank	✓	✓	✗	✗	Cash, deferred shares and/or superannuation
Origin Energy	✓	✓	40:60 ⁱ	✗	Cash
Leighton Holdings	✓	✓	✗	✗	Cash

^a Top 20 ASX-listed companies by market capitalisation as at 30 June 2008. Details in this table relate to 2008 annual reports. ^b Does the remuneration report specify the relative weighting between non-financial and financial hurdles? ^c Level of performance specified for safety targets, however the targets for business/financial and personal performance objectives are unclear. ^d Or cash-settled equivalent. ^e Some employee choice. ^f No bonuses in 2008. ^g Can be partly or entirely deferred into shares as part of a salary sacrifice arrangement. ^h Achievement of any short-term incentive hurdle also provides access to a 'deferred compensation' scheme, entitling recipients to shares or options. ⁱ For the managing director. For other senior executives, at least 33 per cent of the short-term incentive to be based on financial targets.

(Continued next page)

Table 7.4 (continued)

Company	Performance hurdles				Form of payment
	Non-financial hurdles	Financial hurdles	Specify relative weighting? ^b	Specify level performance for payment?	
Macquarie Group	✓	✓	x	x	Cash, deferred shares and managed fund equity ^j
Newcrest Mining					
• 'Salary at risk'	✓	✓	50:50	x	Cash
• 'Medium term incentive'	x	✓	..	✓	Deferred shares
News Corporation ^k	x	✓	..	x	Cash and deferred shares ^d

^j 20 per cent of 'profit share' must be retained as equity in a Macquarie-managed fund for ten years. ^k Also listed on the New York Stock Exchange. Remuneration disclosure is consistent with US standards. .. Not applicable.

Sources: Company annual reports.

Table 7.5 Short-term performance hurdles for other selected companies^a

Company	Performance hurdles				Form of payment
	Non-financial hurdles	Financial hurdles	Specify relative weighting? ^b	Specify level performance for payment?	
ABB Grain	✓	✓	x	x	Cash
Alumina	✓	✓	50:50	x	50% cash and 50% deferred shares
AMP	✓	✓	x	x	Cash
Arrow Energy	✓	✓	x	x	CEO: cash Other execs: shares
Boral	✓	✓	50:50 ^c	x	Cash
ConnectEast Group ^d	✓	?	x	x	Cash
Metcash	✓	✓	x	x	Cash
Suncorp-Metway	✓	✓	x	x	Cash ^e
Transurban Group	✓	✓	x	x	Cash
WorleyParsons	✓	✓	40:60	Part ^f	Cash

^a These ten companies were randomly selected from the ASX100 index (excluding the top 20 companies). Details in this table relate to 2008 annual reports. ^b Does the remuneration report specify the relative weighting between non-financial and financial hurdles? ^c For most executives, although 33:67 for 'Executive General Managers'. ^d 'Milestone retention bonuses' were also paid (in cash) for achieving key milestones. ^e Employee can direct cash bonus into shares or superannuation contribution. ^f No payment if net profit after tax is less than 90 per cent of Board approved budget. Size of payment determined by outcome against key performance indicators.

Sources: Company annual reports.

Table 7.6 Long-term performance hurdles for top 20 companies^{a, b}

Company	Hurdle is relative TSR?		Other hurdle?
	✓	Comparator group(s)	Hurdle type(s)
BHP Billiton	✓	Mining companies (75%), oil and gas companies (25%)	✗
Rio Tinto	✓	HSBC global mining index, 10 international mining companies ^c	✗
Commonwealth Bank	✗		✓ NPAT, customer satisfaction
Woodside	✓	11 international peers (oil and other energy, resources companies)	✗
Telstra	✗		✓ Return on investment, TSR
National Australia Bank	✓	ASX50 companies (50%), top 12 ASX-listed financial companies (50%)	✓ Cash earnings, ROE growth
Westpac	✓	Top 13 ASX-listed financial companies	✗
ANZ	✓	10 ASX-listed financial companies	✗
Fortescue Metals ^g	✗		✓ Share price ^h
Westfield	✗		✓ Varies ^j
Woolworths	✓	ASX100 companies, excluding finance and resources sectors	✓ EPS growth
Wesfarmers	✗		✓ Relative ROE ^k
QBE Insurance	✗		✓ ROE
CSL	✓	ASX100 companies, excluding finance and resources sectors	✓ EPS growth
St. George Bank	✓	Top 13 ASX-listed financial companies	✓ EPS growth
Origin Energy	✓	ASX100 companies	✗
Leighton Holdings	✓	ASX100 companies	✓ EPS growth
Macquarie Group	✗		✓ Relative ROE ^m
Newcrest Mining	✓	Selection of peers from FTSE Gold Mine index	✗
News Corporation ⁿ	✗		✓ Operating profit ^o

^a Top 20 ASX-listed companies by market capitalisation as at 30 June 2008. Details in this table relate to 2008 annual reports. ^b Acronyms are as follows — CSE: cash-settled equivalent; EPS: earnings per share; NPAT: net profit after tax; ROE: return on equity; PR: performance rights (or equivalent); TSR: total shareholder return. ^c Three long-term incentive schemes operate: a share option plan (with performance measured against the HSBC global mining index over a three year period); the 'mining companies cooperative plan', which pays in either shares (performance rights) or cash (with performance measured against 10 international mining companies over a four year period); and the 'management share plan', which is not available to directors of the company (and for simplicity, has been excluded from this table). ^d Both hurdles relative to a peer group, but relative weighting not stated. Hurdle for customer satisfaction specified, similar details associated with NPAT performance are not. ^e Options linked to relative TSR, PR to earnings hurdle.

Specify level performance?		Vesting (years)	Form of payment	Company
Relative TSR	Other hurdle			
✓	..	5	PR	BHP Billiton
✓	..	3 or 4 ^c	Options, PR or cash	Rio Tinto
..	Part ^d	3	PR	Commonwealth Bank
✓	..	3–4	PR (or CSE)	Woodside
..	✓	2–4	Options	Telstra
✓	✗	3	Options and PR ^e	National Australia Bank
✓	..	3–5	Options and PR ^f	Westpac
✓	..	3	PR	ANZ
..	✗	3–7 ⁱ	Options ^h and PR ⁱ	Fortescue Metals ^g
..	✗	3–4	Cash-settled PR	Westfield
✓	✓	3–4	Options and PR	Woolworths
..	✓	5	PR	Wesfarmers
..	✗	3	PR	QBE Insurance
✓	✓	2–5	Options and PR ^l	CSL
✓	✓	2–5	Options and PR	St. George Bank
✓	..	3–5	Options and PR	Origin Energy
✓	✓	3–5	Options	Leighton Holdings
..	✓	2–4	Options	Macquarie Group
✓	..	3	PR	Newcrest Mining
..	✗	4	Shares (or CSE)	News Corporation ⁿ

^f Only CEO is eligible for PR. ^g No long-term incentive payments in 2008. ^h The sole performance hurdle for options is that the exercise price must exceed the share price. No vesting period is specified. ⁱ While Fortescue offers a PR plan, it reports that it has never paid employees through this scheme. Relevant performance hurdle not specified, but vesting/retesting period is specified. ^j Varies each year. In 2008, the hurdle was operational segment earnings growth (75 per cent) and targeted level of project development starts (25 per cent). In 2009, only operational segment earnings. ^k Relative to ASX50 companies. ^l Options linked to EPS growth, performance rights to relative TSR. ^m Relative to ASX100 companies. ⁿ Also listed on the New York Stock Exchange. Remuneration disclosure is consistent with US standards. ^o Board discretion. .. Not applicable.

Sources: Company annual reports.

Table 7.7 Long-term performance hurdles for other selected companies^{a, b}

Company	Hurdle is relative TSR?		Other hurdle?	
		Comparator group(s)		Hurdle type(s)
ABB Grain ^c	✓	ASX200 companies (excluding mining sector), AWB and GrainCorp	✓	Share price, ROE
Alumina ^d	✓	100 ASX-listed entities, 30 international mining companies	✗	
AMP	✓	50 industrials from ASX100 companies	✗	
Arrow Energy	✗		✓	Rolling EBITDA
Boral	✓	ASX100 companies	✗	
ConnectEast Group ^f	
Metcash ^g	✗		✓	EPS growth
Suncorp-Metway	✓	Top 50 ASX100 companies (excluding property trusts)	✗	
Transurban Group	✓	ASX100 industrials	✓	EBITDA
WorleyParsons	✓	ASX-listed companies ranked 50–150 by market capitalisation	✓	EPS growth

^a These ten companies were randomly selected from the ASX100 index (excluding the top 20 companies). Details in this table relate to 2008 annual reports. ^b Acronyms are as follows — EBITDA: earnings before interest, taxes, depreciation and amortisation; EPS: earnings per share; PR: performance rights (or equivalent); ROE: return on equity; TSR: total shareholder return. ^c Options are granted according to a share price target. PR are granted according to three hurdles: improvements in return on equity (weighted at 50%), TSR relative to the ASX200 (25%) and TSR relative to key competitors (AWB and GrainCorp) (25%).

The common use of deferred share schemes by some of Australia's largest companies (nine of the top ten by market capitalisation) suggests that short-term incentive payments can be designed to emphasise long-term, sustainable performance. Some companies (for example, Newcrest Mining) have begun to label such schemes 'medium-term incentives'. However, a lack of detail about the terms under which such payments are granted might give rise to shareholder concern. That said, there can be legitimate commercial reasons for not disclosing the metrics for short-term hurdles — for example, where this might signal the company's immediate plans and provide material commercial advantage to competitors.

Almost all companies in the sample stated that they used a mix of hurdles for their short-term incentive payments, but remuneration reports tended to mention only broadly what these indicators covered. The relative weighting between different indicators was rarely disclosed. In almost all cases, the remuneration report did not specify the link between the measured performance outcomes and the incentive payments made. (Disclosure is discussed in chapter 8.)

Specify level performance?		Vesting (years)	Form of payment	Company
Relative TSR	Other hurdle			
✓	✓	3	Options and PR	ABB Grain
✓	..	3	PR	Alumina ^d
✓	..	3	PR	AMP
..	✗	3	Options ^e and PR	Arrow Energy
✓	..	3	Options and PR	Boral
..	ConnectEast Group ^f
..	✓	5	Cash	Metcash ^g
✓	..	3–5	PR	Suncorp-Metway
✓	✓	3	PR	Transurban Group
✓	✓	3–4	PR	WorleyParsons

^d Alumina has two hurdles, weighted 50% each. ^e Only CEO is paid with options. ^f ConnectEast did not have a long-term incentive scheme in 2008, although it proposed a new scheme in 2009 with short-term, medium-term and long-term incentives. ^g Information relates to Metcash's 'long-term retention payments' that applies to executive directors and some members of the executive team. .. Not applicable.

Sources: Company annual reports.

In contrast to short-term incentive payments, most remuneration reports set out the level of payment of long-term incentive payments against the performance hurdle. For example, AMP noted that if its TSR ranking were below the 50th percentile of the comparator group, then none of the performance rights would vest. If ranking were at the 50th percentile, then 50 per cent would vest, if between the 50th and 75th percentiles then vesting is 50 per cent plus 2 per cent for each percentile, with all rights vesting at the 75th percentile or greater. The details of relative TSR hurdles were generally well disclosed, although this was not consistently the case for other types of hurdle.

In general, vesting periods for long-term incentives were typically around three years, with some companies offering phased vesting periods (for example, St. George Bank offered options and performance rights in three tranches, with a third of the incentives vesting after two years, a further third after three years, and the remainder after four). Some also allow 'retesting' of performance hurdles if these are not met at the first opportunity (for example, Westpac allows performance hurdles to be retested four and five years after the grant date).

Box 7.7 Short- and long-term incentives in 2009

Not all companies had produced their annual reports for 2009. Consequently, tables 7.4–7.7 refer to annual reports for 2008. However, a sufficient number of reports have been released to give a broad indication of practices in executive remuneration.

In general, remuneration practices in 2009 were consistent with those in 2008. One common theme reinforced in 2009 was the increasing use of deferred short-term incentive schemes, with several companies introducing new plans or extending existing ones. Revisions to long-term incentive schemes also featured in 2009, with more companies linking pay to relative TSR performance (although at least one company moved away from this hurdle).

- **Commonwealth Bank** has revised its long-term incentive scheme for 2009-10. The vesting period will extend from three years to four, with relative TSR replacing net profit after tax as a performance hurdle. The bank's TSR will be measured against the largest 20 ASX-listed companies (excluding materials and energy companies).
- **Telstra** moved from an absolute, to relative, TSR hurdle in 2009, with performance assessed against an international peer group of telecommunications companies.
- Following a majority 'no' vote on its remuneration report in 2008, **Wesfarmers** cut short-term incentive payments in 2009. The board exercised its discretion to withhold payments eligible under individual performance targets. The company will introduce deferral of short-term incentives in 2010.
- **Macquarie Group** increased the proportion of its profit share scheme that would be retained in deferred shares and Macquarie-managed funds.
- **Newcrest Mining** increased the proportion of executive remuneration 'at risk', with changes to both its short- and long-term incentive schemes. The company replaced its short-term incentive schemes with a deferred share plan. Newcrest replaced its relative TSR hurdle for long-term incentives with a mix of targets (reserves growth, comparative cost position and return on capital employed).
- Executives at **Boral** did not realise any benefits from short- or long-term incentive plans in 2009. The company will restructure CEO remuneration to place a greater emphasis on long-term incentives over base pay and short-term incentives.
- **ConnectEast** proposed new medium- and long-term incentive plans, focussed on performance over 2–3 and 3–5 years respectively. Medium-term incentives will be linked to internal performance targets, while long-term incentives will adopt a relative TSR hurdle.
- **WorleyParsons** introduced a deferral component to its short-term incentive scheme, with some bonuses to senior executives paid in shares. For these deferred shares, WorleyParsons will review performance again one year after granting. The shares may be forfeited if performance is not considered satisfactory.

How well has incentive pay worked?

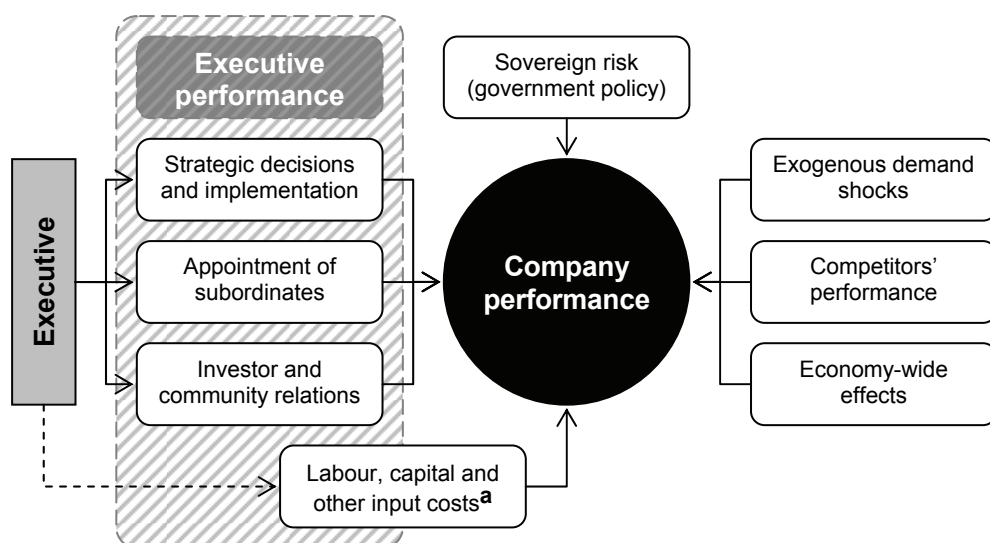
‘Aligning interests’ is distinct from saying that an executive’s pay should be entirely dependent on the company’s performance (as an ordinary shareholder’s investment in the company might be). Executives are not exclusively responsible for a company’s performance, with other external factors likely to have an impact on performance as well (figure 7.2). Moreover, executives will be expected to exert effort and perform on a day-to-day basis. For this they will require remuneration, usually in the form of fixed pay. Incentive pay, additional to this, can be used to drive executives’ actions in the job (and partly substitute for the monitoring of them, which would likely be more costly).

As noted earlier, short-term and long-term hurdles commonly target different aspects of performance. Short-term incentives are generally focused on particular executive actions, whereas long-term incentives tend to align more closely with overall company performance.

From the executives’ perspective

In its 2008 annual report, the Commonwealth Bank indicated that research had shown short-term incentive payments to be ‘the most effective driver of performance’ (Commonwealth Bank 2008, p. 59). Consequently, the bank removed long-term incentives for all but the most senior executives. However, in 2009 the Commonwealth Bank increased the proportion of senior executive’s remuneration tied to long-term incentives, arguing that this would ‘encourage long-term

Figure 7.2 Influences on executive and company performance



^a These are areas that an executive may be able to influence, but will not (likely) have full control over.

shareholder value creation’ (Commonwealth Bank 2009, p. 68). Changes in remuneration practices over time are common, partly reflecting the challenges of calibrating the relative balance between short- and long-term incentives.

The benefits of short-term incentives are sometimes too readily dismissed. Where short-term incentives are tied to pursuing specific strategies or completing specific projects, the tangibility of outcomes could be expected to help focus the performance of executives better than, for example, targeting share price growth over a period of several years.

Moreover, short-term hurdles can (and arguably should) be consistent with long-term performance, where performance is assessed against implementation of new strategies that are intended to drive company growth over subsequent years. Even where short-term incentives focus on immediate performance, long-term outcomes can still be promoted through pay structures. The use by some companies of deferred shares as a short-term incentive (as noted earlier) is consistent with this approach.

Compared with short-term incentives, some participants claimed that executives perceive long-term incentives as akin to a ‘lottery’ (Stern Stewart and Co., sub. 53; Australian Bankers’ Association, sub. 70; KPMG, trans., p. 393). A measure of performance such as relative TSR depends on many factors beyond the control of an executive. While this does not make such payments worthless — the value is the probability of meeting the hurdle multiplied by the price of the instrument — it does mean that their incentive properties are likely to be weakened. Moreover, the value executives place on those instruments is likely to be lower than the accounting value recorded by the company (chapter 4). This effect is likely to be reinforced by the inability of executives to insulate themselves against company-specific risk (unlike ordinary investors who can spread their wealth across a diverse portfolio of investments).

However, there are considerations in the other direction. While ordinary investors are ‘price takers’, executives — because they are responsible for managing the company — must have some influence on the share price (Yang and Chance 2008). In some cases, executives might value equity-based payments at a level greater than the cost to the company. However, this would seem to assume a particularly high level of executive influence over the company’s performance and its share price.

From the shareholders’ perspective

While executives (and analysts) have expressed doubts about the incentive properties of long-term performance hurdles, shareholder groups appear more

enthusiastic. In particular, the Australian Shareholders' Association (ASA, sub. 54) and ACSI (sub. 71) both supported relative TSR as an appropriate benchmark for long-term performance. Two key reasons are that:

- performance hurdles that are linked to market performance (that is, measures such as TSR or relative TSR) should mean that executives are focused on delivering value to shareholders over time
- market-based performance hurdles are relatively transparent, limiting the scope for executives to obtain remuneration that may be seen as unjustified.

However, if the 'lottery' argument has some basis, as is likely, the incentive effects of such a remuneration structure will be weak. Moreover, companies will have to pay more to offset the greater risk to the executive.

The second reason — transparency — is more compelling. Because short-term incentive payments are often granted subject to targets for key performance indicators or other internal benchmarks that might not be disclosed, it is difficult for those outside the company (in particular, shareholders) to verify the performance claims made or understand the executive's performance. The appeal of hurdles such as TSR and relative TSR is that they can be objectively measured. However, transparency is of little benefit if the incentive properties of the hurdle are weak.

Consequently, although short-term incentive payments may be effective drivers of executive performance, shareholders may be less supportive of their use because executive performance against them cannot be directly observed. For example, the ASA urged boards to 'be sparing in the use of short-term incentives, particularly in the case of CEOs, and ensure that at least half of the rewards under these schemes are linked to pre-set, quantifiable financial hurdles' (sub. 54, p. 20).

A balancing act

Boards must balance shareholders' desire for transparency, executives' preference for (incentive) payments based on hurdles that they can significantly (but sustainably) influence the probability of achieving, and the objectives of the company itself.

In practice, many companies adopt a mix of hurdles. With regard to long-term incentives, the ASA (sub. 54) suggested that companies should link payments to at least two different hurdles — one closely aligned with shareholder interests (relative TSR), the other reflecting earnings growth (for instance, earnings per share). ACSI (sub. 71) also advocated a mix of indicators, in particular combining both relative and absolute measures of performance. However, the Australian Bankers'

Association (sub. 70) indicated that split hurdles are not perfect, and that no selection of targets can completely replace the need for board judgment.

Where boards explain what companies' goals are, and how chosen remuneration structures are designed to achieve them, this may provide comfort to shareholders — even if the details of selected hurdles cannot be disclosed up front for legitimate reasons of commerciality.

Risk-taking and 'short termism'

Central to community concern around the global financial crisis is a view that remuneration structures in the financial sector encouraged 'excessive' risk-taking (chapter 1). In the case of major financial institutions, such conduct can pose a threat for other institutions (as counterparties to transactions) or consumers and businesses (who, for example, rely on those institutions to hold deposits or provide access to credit).

In May and September 2009, the Australian Prudential Regulation Authority (APRA) released proposals to reform the regulatory arrangements surrounding remuneration within the financial sector (box 5.4 in chapter 5). It noted that 'sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets for remuneration purposes' (APRA 2009c, p. 11). APRA argued that regulated entities (authorised deposit taking institutions as well as general and life insurers) should adopt pay structures that supported prudent risk management. This is broadly consistent with views overseas on risk-taking, although other proposals have been contemplated (box 7.8).

In terms of different equity-based payments, CGI Glass Lewis and Guerdon Associates suggested that options can encourage risk-taking, while performance rights can make the executive more risk averse than the typical long-term, diversified investor (sub. 80). Large equity holdings can also encourage risk aversion on the part of executives, where a significant portion of their wealth is held in the company's shares. A further concern is likely to be how performance hurdles are used, and whether these are able to ensure that an executive is appropriately concentrated on the company's performance over time.

The problems that APRA identified within the financial sector might also be relevant for executive remuneration practices elsewhere in the economy. Regnan argued that sustainability in a company's growth was often ignored, in part because:

... executives make decisions whose effects in many cases outlast their tenure and we believe that alignment of executive rewards to better reflect this reality would strengthen Australia's governance practice.

The asymmetry, whereby executives can receive entrepreneurial levels of reward without commensurate personal exposure to financial downside, provides a significant incentive to executives for delivering short-term results, even where these are at the expense of the long-term health of the enterprise or wealth of its owners. (sub. 72, p. 1)

The challenge of ‘short termism’ is closely associated with the assessment of risk. Adverse outcomes might take years to appear, while the gains from pursuing strategies that generate the risks of such adverse outcomes are realised in the short term. Unless performance hurdles have a sufficiently long-term focus, executives might be rewarded for adopting risky strategies, without facing consequences once problems emerge. It is this potential that APRA’s guidelines attempt to mitigate.

Box 7.8 Different approaches to regulating risk-taking and remuneration

Leading up to a September 2009 G-20 summit, policymakers around the world expressed concerns about the role of short-term bonuses in promoting ‘excessive’ risk-taking in the financial sector, and considered a number of policy ideas that might be enacted internationally.

- The French Government argued bankers’ bonuses should be curtailed by restricting the total amount of money financial institutions set aside to pay bonuses (as a proportion of operating income) and/or by setting a fixed cap on the amount any individual financial sector employee can receive as a bonus (Hall 2009). These approaches would risk significant adverse consequences, with a likely restructuring of remuneration packages in favour of fixed pay over performance-based pay, and a potential for at least some bankers to be driven out of the financial sector into other jobs that are not subject to such controls on pay.
- G-20 finance ministers agreed that payment of bonuses should be deferred, with consideration given to replacing upfront cash payments with stock options (BBC News 2009). In principle, options can create alignment between remuneration and long-term performance, since the recipient only benefits if the share price on the underlying security increases before expiry. However, one consequence of this is that options can *encourage* risk-taking, since stable share price performance is not strongly rewarded, even if this were the consequence of a ‘safe’ level of risk-taking.
- Lord Adair Turner, the head of the UK Financial Services Authority, suggested that one way to reduce bonuses in the financial sector would be to levy a tax on transactions taken by financial institutions (Monaghan 2009). The French Government has also suggested such a tax could be used to insure retail bank deposits (Hall 2009). The effect of such a tax would be to reduce banks’ profits, thereby reducing the potential pool from which bonuses (and remuneration in general) could be paid. However, this would also reduce shareholders’ returns, and would appear to be a needlessly blunt approach for reducing ‘excessive’ risk-taking.

However, risk has two sides — a positive when the risk pays off, and a negative when it does not. There is by definition no way of knowing which outcome (either positive or negative) will eventuate until it occurs. Efforts to limit the negative outcomes from risk will inevitably curtail its potential for positive returns as well. This might not be in shareholders' (or indeed the community's) interests. Specifically, since higher returns result — on average — from higher levels of risk, restricting risk will inevitably reduce returns to shareholders.

There are reasons why APRA's guidelines would not all be appropriate on an economy-wide scale. First, the majority (in quantity) of APRA-regulated institutions are not listed on the ASX. Hence APRA's specific financial sector guidance is justified on the basis that many of the remuneration guidelines relevant to public companies (chapter 5) do not apply. Moreover, many of the people likely to be covered by the APRA guidelines are non-executive employees — including market traders and sales personnel.

Second, most companies and industries do not pose the same systemic risks to the broader economy as the financial sector. For example, the collapse of a bank can threaten counterparties, causing consumers to panic and withdraw funds from, and place pressure on, other institutions. These broader consequences may not ordinarily be accounted for by the boards of particular institutions.

For most other companies, there are probably few (if any) such 'contagion' effects. The costs of 'excessive' risk-taking are borne mainly by the company and its stakeholders (including employees). Given the essentially internalised nature of this cost, boards have a strong incentive to account for risk in structuring remuneration packages. This could be achieved by adopting a mix of short-term and long-term incentives, with performance hurdles being tested over different time spans. A related mechanism is for companies to defer payments to executives subject to validation of performance after the deferral period (potentially months or years). (However, consistent with the earlier discussion on short- and long-term incentives, APRA (2009c) also warns that excessively long deferral periods can significantly weaken performance incentives.)

Finally, what constitutes 'prudent' risk can vary between industries, between companies and over time. In some circumstances — for example, in the resources or technology sectors — risk-taking is highly desirable. Efforts to curtail risk might limit innovation in many markets (or indeed, in the development of entirely new markets). Shareholders in these cases might expect executives to take substantial risks, and remuneration structures should be expected to reflect this. (Further, risk-averse shareholders can mitigate their own exposure to risk by diversifying their portfolios.)

Of course, companies might not always structure remuneration packages appropriately. As CRA Plan Managers noted:

Less volatile businesses may adopt performance aggressive remuneration structures, but this would almost certainly lead to a mismatch between their business strategy and their remuneration strategy. (sub. 103, p. 8)

An aggressive performance remuneration structure for a less volatile business might contribute to ‘excessive’ risk-taking. However, it is unclear how such imprudence might be identified by external parties before problems emerge. In the absence of external costs, boards are likely to be best placed to make assessments of appropriate risk-taking for their companies.

Can complexity be reduced?

Both the forms of pay (particularly equity-based pay) and the use of performance hurdles have proven to be complicated in practice, which can lead to misunderstanding and mistrust. This factors in the diversity of views on the link between pay and performance (box 7.9). For example, some inquiry participants questioned why executives should be paid any differently from other workers (for example, Ken Thompson, sub. 19; Kenneth Park, sub. 21).

There also appears to be unease amongst some directors. In a speech to the AICD, former Wesfarmers CEO Trevor Eastwood argued for a return to a predominantly fixed pay structure, to improve transparency:

I think the idea is quite radical: to basically go back to fixed remuneration ... No incentives, no share schemes and if you want shares, buy them ... Companies will then be able to judge more precisely salary increases against average earnings, inflation and long-term changes to a company’s financial reckoning. They and the shareholders will be able to easily understand the consequences of the changes and remuneration reports will be able to be brief and understood. (cited in Sharp 2009a, p. 3)

As discussed in chapter 4, complexity — whether it arises from the form of pay (equity), the conditions imposed (performance hurdles), or the interaction of the two — may ‘camouflage’ remuneration levels and drivers, while not necessarily generating stronger incentives for executives to perform in the interests of shareholders. Greater simplicity could have advantages in both respects.

Charles Macek broadly agreed with Eastwood’s sentiments, supporting (in principle) a simple system of fixed pay coupled with discretionary bonuses. However, he believed the approach would be impractical because:

... such a back to the future approach requires trust. Today that trust of Boards by shareholders does not exist. Neither, I suspect, is there sufficient trust of Boards by

management to exercise such discretion in an objective and fair manner. (sub. 55, p. 12)

Trust is clearly a crucial factor. Any principal–agent relationship will break down where trust is lacking. In the case of the relationship between shareholders and boards on the one hand, and boards and executives on the other hand, there will always be informational asymmetries. Trust can be promoted by transparency, although promoting transparency may jeopardise other desirable objectives.

For example, one of the arguments in favour of long-term incentive payments, where performance is assessed against such metrics as relative TSR, is that the reported performance outcomes can be easily verified. Yet, as noted earlier, if the incentive properties of such payments are weak, the emphasis on transparency may cause the effect on performance to be missed. Shareholders might not be aware of this tradeoff. By the same token, poor disclosure might not always be justified by commercial sensitivity (chapter 8).

Box 7.9 The *Harvard Business Review* debates executive pay

In the middle of 2009, several academics, executives and remuneration industry practitioners contributed to an online debate on executive remuneration, hosted by the *Harvard Business Review*. A summary of their views on the link between pay and performance is offered here.

- Kaplan (2009) found executive pay to be strongly correlated with performance. This contrasts with Delves (2009), who claimed that many board members believe executive pay is too high and that the link with performance is not sufficiently strong.
- Sheehan (2009) argued that executive remuneration has caused ‘excessive’ risk-taking by companies.
- Narayanan (2009) emphasised that pay structure rather than quantum is important. Fernández-Aráoz (2009) contended that the question of pay levels is less important than employing the right CEO and other senior executives in the first place.
- Bebchuk and Fried (2009) observed that although equity-based pay has the potential to drive performance, such arrangements are often poorly structured, allowing executives to capitalise on short-term (temporary) gains in the share price. To counter this, they proposed staggering the payment of vested equity. Landry (2009) argued this would be unnecessarily complex, and boards would not properly adopt such a scheme. He favoured deferred shares as a simple mechanism for aligning an executives’ interests with those of the company over the long term.
- Martin (2009) warned against linking pay to share price performance because executives have little ability to directly influence the share price (legitimately). By contrast, metrics such as EPS or market share reflect areas over which executives can exert greater control. Moreover, performance improvements in these areas will still lead to creation of shareholder value.

'Vanilla' remuneration structures pose risks

CGI Glass Lewis and Guerdon Associates warned that some boards had felt obliged to adopt performance measures that 'are ineffective and inappropriate in some circumstances but which are utilised because they are prescribed by various governance and stakeholder groups' (sub. 80, p. 97). Put another way, boards feared that if they failed to adopt the performance measures set out by those groups, then their remuneration reports would be voted against.

Of course, what companies may perceive as shareholders 'not listening' could in fact be shareholders simply disagreeing with the remuneration structure being proposed. In these circumstances, even if companies believed their remuneration approach were justified, they might not have explained their reasons sufficiently well. (This may be more likely where companies pursue a remuneration approach different from peers, since shareholders may not be familiar with what is proposed.)

Nevertheless, it is conceivable that shareholders (and groups acting on their behalf) may prefer consistency across companies, and this could translate into pressure on companies to adopt specified forms of pay and performance hurdles. Standardised approaches to pay structures can be easier to understand and facilitate cross-company comparisons. Such 'rules of thumb' are particularly likely to have appeal where the portfolios held by investors are quite diverse.

However, uniformity can have downsides. The Business Council of Australia observed:

If variable pay is to be closely aligned to real drivers of company performance over time, a greater diversity and indeed complexity of measures and targets is required within and across companies. This should not be surprising. Large companies are complex as are the vast majority of contracts that relate to their operation. (sub. 101, p. 14)

That companies are different is generally acknowledged — indeed, it is a fundamental principle behind the ASX Corporate Governance Council's 'if not, why not' disclosure regime (chapter 8). Consequently, 'prescribed' or standardised pay structures might not be helpful in promoting improved performance (in much the same way that imposing standardised investment strategies across all companies would not be appropriate), yet could also be driving unnecessary complexity.

If every company is different, how are shareholders to know whether any individual company has selected appropriate remuneration structures? As CGI Glass Lewis and Guerdon Associates argued:

In most instances it is probably better to provide reward in a mix of cash, share rights, share options and shares to overcome much of the agency costs. But there is no 'right'

mix. It will depend on the company's strategy, opportunity, cash flow, capital structure and requirements, and its stage of maturity. The implication is that over time the 'right' mix will change.

In short, the mix is somewhat of an art requiring business judgment of the stage that the organisation is at. Given the complexities, the board is in the best place to exercise this judgment because it has the requisite inside knowledge of the business. (sub. 80, p. 26)

Whether or not complex performance hurdles represent over engineering (either by boards directly or in response to shareholder pressure) remains contentious. Perversely, while the complexity of some remuneration packages may have been intended to influence executive performance with greater precision, too narrow a focus on particular incentives might have led to unanticipated results in other areas or larger than expected payments. Boards are already likely to be aware of such possibilities, but they might find benefit in explaining to shareholders how they avoid these outcomes. This is considered further in chapter 11.

Additionally, requiring executives merely to hold shares in the company for an extended period of time might achieve similar performance outcomes to more complex structures (box 7.10). Notably, some companies have begun to offer deferred shares as part of their short-term incentive plans in place of cash bonuses, although they still use options and performance rights for their long-term incentives.

7.2 Non-recourse loans

Particular aspects of remuneration might be sufficiently problematic to justify policy interventions. Three areas identified in the terms of reference for this inquiry are considered in this and subsequent sections.

Some companies grant executives access to loans as a benefit of their employment. The terms of reference for this inquiry request that the Commission specifically consider 'the issue of non-recourse loans used as part of executive remuneration'.

What are non-recourse loans?

A 'non-recourse' (or, technically, 'limited recourse') loan is secured only by the asset purchased (the shares), with the lender having no claim to the borrower's other assets in the event of default. (This contrasts with 'full recourse' loans, where the borrower is fully liable to repay the loan.) Non-recourse loans are typically offered to executives on an interest-free basis, with dividends earned from the shares used to pay off the loan. Consequently, the shares come at no monetary cost to the

Box 7.10 Promoting alignment and simplicity: deferred share schemes

Remuneration structures continue to evolve. One feature demanded by shareholders (for example, ASA, sub. 54), and now adopted by some companies (tables 7.4 and 7.5) is to link short-term incentive payments to performance over a longer timeframe. This is commonly achieved through the use of deferred share schemes.

While long-term incentives often rely on applying performance hurdles over a period of years to determine if and when payments should be made, a deferred share scheme might only be contingent on meeting a performance hurdle in the short term, then requiring executives to retain the granted shares for a defined period. The effect is to link a portion of executives' wealth to the company's ongoing performance, beyond the assessment of performance at the grant date. (Holding locks applied to options and performance rights post-vesting have similar benefits.) Deferred share schemes can also act as 'retention' payments, such that executives who depart a company before the conclusion of the deferral period risk forfeiting their shares.

Deferred share schemes provide a simpler form of remuneration than options or performance rights. Nevertheless, such schemes have considerable potential to align the interests of executives with those of the company (and shareholders).

The effectiveness of deferred share schemes as an incentive for driving company performance will depend on the appropriateness of the initial hurdle (if any), and the degree to which any individual executive believes he or she can influence shareholder value. Deferred share schemes might also contribute to executives' risk aversion (which may or may not be desirable, depending on the company's risk profile), particularly if a large portion of their wealth is tied up in such schemes.

executive, although the loan must be paid in full before the executive can exercise rights over the shares (for example, to sell them). Non-recourse loans can also be available for other employees, not just executives, often as part of an employee share scheme (AICD 2008b).

Participants have indicated that non-recourse loans are not very common (for example, ASA, sub. 54; Chartered Secretaries Australia, sub. 57; Macquarie Group, sub. 52). The Australian Human Resources Institute, in a survey of its members on executive remuneration in April 2009, reported that only 4 per cent of companies offered non-recourse loans to executives, with 2 per cent of executives receiving such loans (based on responses from 150 specialist practitioners within ASX200 companies) (sub. 49).

While Australia does not directly regulate the use of non-recourse loans (although disclosure is required), some countries have chosen to restrict the ability of companies to lend money to executives (box 7.11).

Box 7.11 Regulation of loans to executives and directors

Australia

Non-recourse loans are primarily regulated in Australia through requirements to disclose remuneration of key management personnel in the remuneration report (section 300A of the Corporations Act and the Australian Accounting Standards Board Standard 124). If such loans are significant, they might also be regulated indirectly through:

- section 260A of the Corporations Act, which states that a company can only offer financial assistance to a person to buy shares in the company if the assistance does not materially prejudice the interests of the company, or under approval of shareholders by special resolution (an exemption applies if the financial assistance is provided through a shareholder-approved employee share ownership scheme)
- ASX listing rule 7.1, which requires prior shareholder approval if total shares issued in the past 12 months exceeds 15 per cent of total shares on issue
- ASX listing rule 3.1, which requires that if 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 disclose that information to the ASX.

Overseas

In the United States, the Sarbanes-Oxley Act 2002 prohibits US companies from lending money to executives. Similarly, companies in France, Sweden and Denmark are strictly prohibited from making loans to executives.

Some European countries allow loans to be made to directors but only on approval of the supervisory board. (Some European countries require companies to have two boards — one, the management board, comprising only executive directors; the other, the supervisory board, comprising only non-executive directors.)

In the United Kingdom, companies are allowed to extend loans to *executives*, without disclosure requirements, although they are prohibited from extending loans to *directors* (including executive directors) without shareholder approval.

Incentive misalignment?

In principle, non-recourse loans could be expected to facilitate alignment between executives and shareholders, because they are used to purchase shares — giving executives ‘skin in the game’ without requiring a direct monetary outlay on their part. The Investment and Financial Services Association considered that equity participation should not involve non-recourse loans (IFSA 2009). Similarly, ASA (2009) guidelines state that there should be no company loans associated with long-term incentives as this decouples incentives and is an inappropriate use of shareholders’ funds. By contrast, although ACSI (2009a) does not support loans to

executives on a non-commercial basis to purchase shares, it will support non-recourse loans where, if the shares acquired under the arrangement are forfeited, the company can sell the shares to recoup some of what is owed by the executive. ACSI also notes that using newly issued shares in such schemes can minimise potential cash losses to a company.

A common argument against non-recourse loans is that they limit the downside risk in executives' remuneration. For example, the AICD (2008c) contends that non-recourse loans can weaken the link between remuneration and performance by diluting the 'at risk' aspect of share ownership, as the wealth of the executive is not threatened if the company's share price falls. If the share price declines significantly, the executive can simply forfeit the shares. The company then bears the risk of funding any shortfall between the value of the shares and the outstanding loan amount.

In designing incentive pay, a fundamental principle is that boards should seek to align the risk profiles of executives with those of the companies they work for (section 7.1). In many cases, particularly for mature companies, an objective in designing remuneration policies might be to limit risk-taking. Non-recourse loans are unlikely to be appropriate for these businesses. But for other companies, particularly startup ventures or failing enterprises (where boards need to attract new talent to try and turn the company around), risk-taking could be essential. In these circumstances, boards might consider that structuring remuneration to limit downside risk is appropriate (especially for a risk-averse executive who might otherwise require higher remuneration in other forms to offset the risk). Non-recourse loans could be a useful instrument for achieving this compared to other mechanisms (box 7.12).

Nevertheless, non-recourse loans create uncertainty for companies in the event of share price declines. While a share grant involves a known cost, a loan might be fully repaid, or it might not be. The potential cost to the company will depend on the willingness of the executive to forfeit shares and the extent of any share price decline, as well as any interest costs. (Having said this, the maximum potential cost of an abandoned loan is known, since the share price cannot fall below zero.) Boards (and shareholders) may prefer pay structures that offer more transparent costs to the company.

There are alternative forms of remuneration that may be able to produce similar incentive effects to non-recourse loans — for example, a combination of fixed pay with shares or options. However, such approaches might expose the company to higher costs for successful performance. For example, as an option is worth less

Box 7.12 Substitutes for non-recourse loans

The effect of lending executives money to acquire shares should be contrasted with simply granting them shares outright. In the case of a direct grant, companies (and their shareholders, in the case of newly issued equity) face a clear cost that is not intended to be recovered. Even if a non-recourse loan is abandoned by an executive, the company will still be able to sell the secured shares and recover some value (unless the share price falls to nil) — the net cost to the company per share will be smaller than if they had granted the shares to the executive. (However, granting shares and lending money to buy shares are not perfect substitutes. Hence the same quantity of shares might not be offered.)

In this context, the downside risk to the company is *reduced* through lending rather than granting. On the upside, the company enjoys the benefit of an executive whose interests are aligned with those of the company and shareholders (they now own shares, which they want to see increase in value) without having faced a significant cost (aside perhaps from the interest forgone on the loan). The upside potential to the executive might be constrained relative to a share grant, depending on the conditions of vesting and whether dividends are payable to the executive.

Non-recourse loans do expose executives to less downside risk than full recourse loans (where a company could recover the full value of the loan from *any* of an executive's assets). However, it is unlikely (at least in all cases) that full recourse loans would be offered in the absence of non-recourse loans. The different risk implications for both the executive and the company might mean the two types of loan are not direct substitutes.

than the underlying share, more options would need to be granted than the quantity of shares obtainable through the loan. As the share price increases above the option's exercise price, the cost to the company if the option is exercised also increases. In this case, the uncertainty associated with costs if the share price declines is replaced by uncertainty about the costs of remuneration where the share price increases — the only difference being that the share price, and therefore the maximum potential cost to the company, faces no limit on the upside. (Of course, since the share price reflects the company's performance, a higher share price is a desirable outcome — although it might result in a higher cost, in terms of acquiring equity to remunerate executives.)

Policy implications?

Some inquiry participants considered the current regulation of non-recourse loans to be sufficient. For example, Chartered Secretaries Australia observed that non-recourse loans 'are transparent and required to be reported to shareholders via the remuneration report' (sub. 57, p. 42). The AICD (sub. 59) and the Australian

Bankers' Association (sub. 70) observed that it is the role of boards to assess the appropriateness of non-recourse loans.

Others took the view that non-recourse loans should be prohibited. For example, the Finance Sector Union claimed that 'allowing these loans for executives who can directly affect share price misaligns shareholder and executive interest' (sub. 39, p. 7). The ASA noted it 'may be appropriate to regulate to prevent such loans being made' (sub. 54, p. 21).

On balance, it appears hard to justify the banning of non-recourse loans. The perceived risks associated with such loans appear overstated, particularly when compared to some other commonly used instruments. Further, although non-recourse loans can impose costs, each company would need to weigh these against the potential benefits. While many companies are likely to find non-recourse loans unsuited to their circumstances, such loans could be an effective instrument for aligning risk profiles for some companies. Nevertheless, it remains important, as with other vehicles for incentive alignment, that non-recourse loans and the contingent liability being incurred by companies are transparently disclosed to shareholders.

7.3 Hedging of incentive payments

Hedging involves the use of financial instruments to reduce financial risk. The terms of reference ask the Commission to consider 'the use of hedging over incentive remuneration', paying regard to the implications for the alignment of interests between executives, boards, shareholders and the wider community.

Equity-based payments and performance hurdles are designed to align the executive's interests with shareholders by linking pay to performance (section 7.1). Hedging of incentive payments using financial products (for example, 'put' options, which pay off when share prices fall) can reduce risk and enable executives to transform 'at risk' pay to fixed pay (at a cost). This undermines the intention of such schemes and breaks the link to performance. There are, however, other possible actions an executive could take to mitigate exposure to company-specific risk (box 7.13).

At any point in time, equity remuneration for executives can take three different forms:

- unvested shares or options (that is, before performance hurdles have been achieved or service conditions fulfilled)

-
- vested but subject to a holding period (that is, the executive has met any hurdles, but cannot sell the shares yet)
 - vested, with the executive able to sell the shares.

Box 7.13 Hedging in other guises

A common way for investors to hedge against company-specific risk is to invest in a diverse portfolio of stock (or other assets). Similarly, executives could invest their private wealth in a selection of companies, complementing shareholdings in their own companies (acquired as a result of equity-based remuneration). Declines in the value of employment-related shareholdings might be offset by gains in other investments. While this is not generally a concern, such diversification could cause executives to take greater risks than intended by the design of their remuneration packages.

The risk aversion of executives could also act in a contrary way, such that executives' own behaviour becomes a *de facto* form of hedging. For example, in order to protect the value of their shareholdings in the company, executives might reject riskier long-term projects that offer the potential (but not a guarantee) to deliver strong growth opportunities. Pursuing such projects could be in a company's (and shareholders') interests, but if executives believe their 'at risk' pay is too risky, they might choose less risky projects with more certain payoffs to limit the company-specific risks they face.

Although there are some concerns about hedging all of these forms of equity, concerns principally relate to *unvested* equity. There is currently some regulation relating to hedging of incentive payments, and various corporate governance guidelines also offer comments on the practice (box 7.14).

Share trading policies

In 2006, concerns were raised in the media about executives hedging their long-term incentive remuneration, the lack of company awareness of this practice and the absence of policies for dealing with it. Consequently, ACSI surveyed ASX200 companies on whether they had a policy that permitted hedging of such remuneration. Of the 120 respondents, 63 respondents (53 per cent) had a share trading policy covering hedging. Of those companies, none allowed hedging prior to vesting with about a third allowing hedging of *vested* equity (ACSI 2006).

In June 2007, the Corporations Act was amended to require that board policy on hedging be outlined in the remuneration report.

According to the ASX (2009a), while a high percentage of entities reported the existence of a trading policy (86 per cent) in 2007-08, fewer actually disclosed the

terms (66 per cent). Many of the entities neither establishing nor disclosing a trading policy were listed on the ASX All Ordinaries index (the top 500 listed entities by market capitalisation).

Box 7.14 Regulation and guidance on hedging of incentive payments

The Corporations Act requires that if an executive's remuneration includes securities (shares or options), then the remuneration report should discuss board policy on the executive limiting exposure to risk (hedging) in relation to those securities and the mechanism to enforce the policy (section 300A(da)). This requirement is relatively recent (June 2007).

The ASX Corporate Governance Council's principles and recommendations discourage hedging of *unvested* entitlements, although they do not formally 'recommend' prohibiting hedging of incentive payments. Rather, it recommends that companies establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy (recommendation 3.2). In formulating a trading policy, it *suggests* companies consider prohibiting 'designated officers from entering into transactions in associated products that limit the economic risk of security holdings in the company over unvested entitlements' (ASX Corporate Governance Council 2007a, p. 23). The Council also recommends that companies publicly disclose the company's policy on hedging unvested entitlements under equity-based remuneration schemes (recommendation 8.3).

ACSI guidelines do not support executives hedging unvested share options, and encourage companies to disclose any policy on option hedging. Where a company permits directors and executives to hedge vested incentives, ACSI (2009a) considers the company should disclose such practice, by informing the market within two days of any hedging occurring.

The AICD observed that good corporate practice regarding executive option hedging includes:

- having a written and published policy on hedging of executive options or shares
- prohibiting hedging of unvested options or shares
- considering disclosing hedging of vested options or shares
- considering a mechanism for executives to report on hedging
- treating breaches of policy seriously (sub. 59, p. 62).

The ASA stated that 'boards must not permit executives to enter into arrangements (such as hedging) which reduce the risk elements essential to effective incentive schemes' (2009, p. 2).

Table 7.8 Share trading policies in top 400 companies^a in 2008 annual reports

	<i>Top 250 companies</i>	<i>Companies ranked 251–400</i>
	% all companies	% all companies
Share trading policy exists:	80	40
• Rigorous and well defined policy	46	na
• Policy considered to be soft	33	na
Share trading policy does not exist ^b	20	60
Total	100	100

^a By market capitalisation. ^b Includes those companies with a policy that contained no constraints on share trade that were not already required by law. **na** Not available.

Sources: WHK Horwath (2009a, 2009b).

WHK Horwath reported that 46 per cent of the top 250 companies by market capitalisation had a rigorous and well defined share trading policy in 2008, with 33 per cent considered to have a ‘soft’ policy (table 7.8). Larger companies were more likely to have share trading policies, with only 40 per cent of mid-cap companies (those ranked 251–400) having a share trading policy.

Policy-relevant considerations

The Commission has not been presented with or otherwise found evidence that would enable an assessment of the extent to which hedging of unvested entitlements currently occurs. (Two companies reported they did not allow hedging of unvested equity — see Woolworths, sub. 91; BlueScope Steel, sub. 56.) The absence of current examples of the use of hedging might indicate that the disclosure regime and voluntary guidelines have been reasonably effective in stemming this practice. But it could also reflect the fact that hedging is an expensive practice for the executive, given that a third party would need to be compensated for assuming the risk the executive is trying to offload. Consequently, executives might have found little net benefit in hedging strategies, even where they are permitted.

Hedging of unvested equity

Although the practice appears to be uncommon, some participants considered that hedging of unvested equity should be prohibited in the Corporations Act (box 7.15).

As section 7.1 identified, performance-based pay is typically complex. These pay structures are specifically designed to expose executives to company-specific risk, to concentrate their efforts on driving company performance. But where executives

can hedge against the company-specific risk, this clearly undermines the spirit (if not the letter) of their contract. Notwithstanding the complexity of remuneration arrangements, it is difficult to see how this benefits companies or shareholders.

Box 7.15 Regulation of hedging of incentive payments — views from submissions

The Finance Sector Union (sub. 39) and ACSI (subs. 71 and DD156) argued that hedging of unvested remuneration should be explicitly prohibited in the Corporations Act. However, the AICD warned that black letter law might not prove effective given the complexities of hedging arrangements, and the difficulties in legislating for all possible vesting conditions and trading limitations (sub. DD149).

Chartered Secretaries Australia (subs. 57, and DD147) and Macquarie Group (sub. 52) contended that executives should be permitted to hedge vested remuneration.

CGI Glass Lewis and Guerdon Associates considered it reasonable to allow hedging of vested equity without holding locks (sub. 80).

ACSI suggested the Corporations Act be amended to require disclosure of any hedging on vested equity:

... where hedging of vested incentives arises, the company should inform the market about the transaction within 2 days of it occurring. (sub. 71, p. 16)

Chartered Secretaries Australia stated that directors' hedging of shares should be disclosed (sub. 57).

Although permitting an executive to hedge might reduce their exposure to risk, there are other mechanisms that would achieve the same effect — for example, paying a higher proportion of base salary. Those alternatives would be more transparent to shareholders.

Hedging of vested equity

The arguments on whether executives should be able to hedge *vested* equity-based payments are less straightforward. Vested equity can either be subject to a holding requirement, or executives can be free to sell the equity if they choose.

Some participants argued that the application of holding locks should not prevent executives from hedging equity. For example, PricewaterhouseCoopers stated:

If ... the equity has vested, albeit it remains subject to a holding lock, we suggest that executives should be able to hedge this equity if they so desire. This is because once the equity has vested, the executive is absolutely entitled to it and, subject to trading restrictions and company policies, it becomes similar to other personal investments. (sub. DD138, p. 5)

However, boards usually impose holding requirements on vested equity to continue aligning the interests of executives with shareholders beyond the achievement of hurdles. To the extent that boards pursue this strategy, it would seem counterproductive to allow executives to hedge such equity (as with unvested equity).

Vested equity not subject to any holding period is in a different category. In this case, executives are *voluntarily* choosing to invest their wealth (past income) in the company (as they are free to sell the equity). To the extent that executives voluntarily choose to hold wealth in the companies that employ them, they should be able to hedge the risk involved (an option available to all shareholders in that company). Permitting such hedging might also lower remuneration costs for the company given portfolio risk premiums. Nonetheless, disclosure of such hedging can reduce any perception of insider trading.

7.4 Issues with termination payments

Termination payments, made when employment ceases, can comprise any or all of cash, accelerated vesting of equity, accrued leave entitlements and retirement benefits. The Commission has been asked to consider ‘the role of, and regulatory regime governing, termination benefits’, with specific reference to ‘the role of accelerated equity vesting arrangements’ (box 7.16).

A company might wish to make a termination payment for a range of reasons, including:

- rewarding an executive for long service or outstanding performance
- discouraging a departing executive from disclosing company ‘secrets’ to rivals or generating negative publicity about the company
- luring a talented executive from a secure job into a riskier position, such as turning around a faltering company (providing a minimum reward even if their efforts are not enough to save the company)
- ensuring a CEO or senior executive does not have an incentive to spoil merger negotiations or efforts to restructure the company that might result in him or her being deposed (Stapledon 2005).

Box 7.16 Accelerated vesting of equity

Boards currently have the discretion to waive vesting conditions related to performance-based payments, in order to allow executives to benefit from long-term incentive plans (or deferred short-term incentive plans) even if performance hurdles or time-based service requirements have not been met. This could be a cause for concern. The incentive properties of performance hurdles or service conditions are likely to be undermined by ‘moving the goal posts’, or at least a perception that this might occur. For instance, where an executive operates on the belief that vesting conditions will be relaxed upon departure, this could influence behaviour in a way that is undesirable for the company and its shareholders.

Nevertheless, there are cases where accelerated vesting might be justified. For example, where termination benefits are to be paid, accelerated vesting of existing entitlements might be a less costly mechanism for a company to pay a departing executive than cash. Moreover, granting an executive full rights to equity upon departure could act as a possible (although imperfect) signalling device to shareholders. If an executive retains shares voluntarily after departing, this might express confidence to the market about the strength of the company’s position. If the executive chooses to sell the shares, then other shareholders might — in the absence of another plausible explanation — interpret this as a sign that the executive believes the company’s performance will decline. (However such a signal would need to be interpreted cautiously, since an executive might sell shares for a number of reasons. For example, an executive who retires from a company might sell shares simply to finance his or her post-workforce lifestyle. This should not alarm shareholders.)

Accelerated vesting of at least a portion of equity might be required to cover tax obligations, depending on other policy changes (chapter 10).

Notwithstanding these legitimate purposes for termination payments, there is significant community and shareholder concern about ‘golden handshakes’, particularly where granted at a time of poor company performance. Shareholders typically perceive termination payments as remuneration for which companies derive little or no value — such payments, particularly when made on an *ex gratia* basis, are unlikely to influence future company performance. Contracted termination payments might also be problematic, as they could distort executives’ performance incentives. In particular, since large guaranteed payments could allow for failure to be rewarded, executives might not be sufficiently motivated to perform. Reflecting these concerns, termination payments beyond a certain size involve greater shareholder scrutiny and approval than other forms of pay.

Recent and current arrangements

The size of termination payments in Australia is not directly limited by regulation. Rather, under the Corporations Act there is a requirement for *shareholder approval* in certain circumstances — in particular (in current legislation), where the proposed payment exceeds a prescribed multiple of the executive’s remuneration package (averaged over the past three years). Companies are also required to disclose termination entitlements in the annual remuneration report. (Other aspects of the regulatory and governance framework pertaining to termination payments are outlined in box 7.17.)

As seeking shareholder approval can be costly (the time and resources required to call a general meeting of shareholders), and given the risk that a proposed termination payment might be rejected, there is an obvious incentive for companies to design termination payments that are less than the trigger specified in legislation. Given concerns that some termination payments in Australia have rewarded failure, the Australian Government introduced reforms to lower the threshold for shareholder approval from seven times total remuneration to an amount equivalent to one year’s base salary, and broaden the scope of what is considered a ‘termination payment’. The changes, detailed in box 7.18, took effect from November 2009.

Trends in termination payments

The AICD observed that in Australia there is a tendency to make lump sum termination payments. It noted that taxation laws — particularly that liability for unvested equity securities is triggered at termination — have resulted in a low incidence of deferring performance-based rewards past termination in Australia (sub. 59). (These taxation provisions are discussed in chapter 10.)

Some termination payments have been large. The Finance Sector Union provided a list of payments made to finance sector executives during their final year of employment (sub. 39). These data, derived primarily from Stapledon (2005), highlighted numerous termination payments between 1999 and 2004 that were many multiples of final year base salary. However, as Stapledon (2005) cautions, because many executives did not complete a full (financial) year’s employment, this ‘final year’ salary was often an understatement. Moreover, some termination payments included other benefits, such as accrued leave entitlements. These factors tended to exaggerate the relative size of the reported termination payments, although many remained substantial.

Box 7.17 Regulation and guidance on termination payments

Australia

Under section 200B(1) of the Corporations Act, a company must not give a director or executive director retirement benefits, without shareholders' approval. There are some exceptions to this rule (set out in section 200F), including if the benefit:

- is given under an agreement made before 1991
- is given under order of a court
- is for breach of contract
- is less than the average of the executive's annual base salary over the past three years (as of November 2009; see box 7.18).

Section 200C of the Corporations Act also requires shareholder approval to provide a benefit to a person in connection with the transfer of the whole or any part of the undertaking or property of the company.

ASX listing rules also state:

- termination benefits cannot become payable to an officer of a company due to a change in shareholding or control of the company (listing rule 10.18)
- shareholder approval is required if total termination payments to officers exceed 5 per cent of the company's equity (listing rule 10.19).

Termination payments can also receive concessional tax treatment (chapter 10).

Guidance

ACSI encourages companies to disclose the potential value of a termination payout when disclosing the contractual arrangements (including termination conditions) for a senior executive (as per ASX listing rule 3.1). It also considers that boards should not pay out excessive and unreasonable termination payments in circumstances where the termination is a consequence of poor and inadequate performance (ACSI 2009a). The ASA considers that termination payments to 'failed' executives above statutory requirements or in lieu of notice are unacceptable (ASA 2009).

Overseas

In the United Kingdom, regulation in effect limits termination payments without shareholder approval to two years pay.

The European Commission adopted a recommendation in April 2009 that termination payments should not be paid where termination is due to poor performance and payments should not exceed two years of base pay (European Commission 2009a).

In the United States and the Netherlands, higher tax rates exist for termination payments above a certain threshold (chapter 10).

Box 7.18 2009 changes to regulation of termination payments

Amendments to the Corporations Act in respect of the threshold and scope for shareholder approval of termination payments entered into law on 23 November 2009. The changes apply only to contracts introduced or altered after this date, and:

- reduce the threshold for shareholder approval of termination payments from seven times total remuneration to one year's base salary (calculated on an average of the preceding three years)
- broaden the definition of 'termination benefit', capturing all payments at termination:
 - long-term incentives that vest after termination will not be considered termination benefits (although any move to accelerate the vesting of such incentives will be captured)
 - superannuation payments above statutory entitlements and any kind of pension will be counted as termination benefits (but a payment from a defined benefit superannuation scheme that was in place when the regulations commence will not)
- expand shareholder oversight of termination payments from company directors only to all key management personnel
- introduce a 'clawback' provision — any unauthorised termination benefits must be repaid immediately
- increase the maximum penalty that may be imposed on an individual for breach of the termination benefit requirements from \$2750 to \$19 800 (retaining the option of six months imprisonment), and on a company from \$16 500 to \$99 000.

Sources: Parliamentary Library (2009); Parliament of the Commonwealth of Australia (2009).

According to Hay Group data, there has been a decline in the relative magnitude of termination payments since 2003 (table 7.9). By 2008, the majority of termination payments made to CEOs and senior executives equalled between 10 and 15 months of fixed pay.

These findings are supported by research from ACSI, which shows that 13 of the companies comprising the ASX20 index set termination pay at less than (or equal to) one year's base salary (Byrne 2009). Further, an Australian Human Resources Institute survey of human resources managers reported that 92 per cent of companies have 12 months fixed pay or less on termination for their CEOs, and 98 per cent of companies have 12 months fixed pay or less for general executives (sub. 49).

Notwithstanding a trend decline on average, community angst may have been fuelled by some high profile cases where termination payments have appeared grossly excessive (box 7.19).

Table 7.9 Termination payments by size, 2003 and 2008
Proportion of all termination payments^a

<i>Months of fixed pay</i>	2003		2008	
	CEO	Senior exec.	CEO	Senior exec.
Bona fide redundancy	%	%	%	%
Less than 3 months	0	0	0	0
3–9 months	0	18	20	20
10–15 months	36	73	60	60
16–21 months	28	0	10	20
22–27 months	18	9	10	0
Greater than 27 months	12	0	0	0
Total	100	100	100	100
Other				
Less than 3 months	10	10	0	0
3–9 months	0	0	27	45
10–15 months	20	70	73	55
16–21 months	30	10	0	0
22–27 months	20	10	0	0
Greater than 27 months	20	0	0	0
Total	100	100	100	100

^a For CEOs and senior executives of organisations contributing to Hay Group databases.

Source: Hay Group (sub. 84, p. 15).

Box 7.19 Reward for failure?

A number of inquiry participants cited cases of executives receiving large termination payments despite poor performance. Regnan (sub. 72) and CGI Glass Lewis and Guerdon Associates (sub. 80) identified Oz Minerals, Transurban and AGL Energy as examples of companies where there were poor practices (chapter 1).

As noted, the Finance Sector Union presented a list of salary, termination payments and total payments for executive departures in the finance sector during their last year of employment. It considered that many of the examples relate to executives who were fired for poor performance. It also argued that most examples ‘demonstrate a disconnect between items declared as “termination” benefits, the salaries paid for a part year and the ultimate payment made for that financial year’ (sub. 39, p. 5).

Potentially compounding concerns over ‘rewards for failure’, companies do not always clearly articulate their reasons for making termination payments. RiskMetrics reviewed 25 CEO departures at ASX20 companies over the period 2000 to 2009, and found no cases where a CEO was disclosed as being terminated:

The most information provided on the reasons for a CEO’s departure was by BHP Billiton in the case of Brian Gilbertson, whose January 2003 departure was described as a resignation following ‘irreconcilable differences’ with the board. In all other cases disclosure indicated that the departure was voluntary but despite this, in 11 cases, termination payments were made. (sub. 58, p. 12)

Anticipated versus realised pay

Participants have observed that reported termination payments do not necessarily equate with the actual amounts paid to departing executives. In some cases, the reported values are lower, with boards appearing to grant amounts larger than they are contractually obligated to pay.

RiskMetrics observed that in some cases ‘amounts actually paid to a departing executive were substantially larger than indicated in prior disclosures’ (sub. 58, p. 11). It noted:

... Adelaide Bank in its 2005 annual report disclosed that the then-CEO, Barry Fitzpatrick, was entitled to one month’s notice on termination, statutory entitlements and that the board had discretion to direct forfeiture of any unvested entitlements. On 19 July 2006, Adelaide Bank announced Fitzpatrick would retire in December 2006 and on 12 September 2006 that he would receive a ‘retirement payment’ of \$8.3 million in addition to superannuation and statutory entitlements, representing 9 per cent of 2006 net profit. (sub. 58, p. 11)

Some commonly reported figures also might overstate the true size of termination payments. The AICD (2008a) observed that some concern with termination pay might arise from misunderstanding or misreporting of figures, with payments for unpaid leave, long service leave and superannuation sometimes labelled as ‘termination pay’. John Colvin (CEO of the AICD) also cited examples of where actual termination payments were significantly below payments reported in the media:

- Suncorp-Metway CEO, John Mulcahy — who was reported to be leaving the company with a payout of \$20 million. His termination payment was approximately \$2 million, with the remainder of the quoted figure comprising his total salary over six years, leave entitlements and equity that would not vest or would be underwater (so would not be exercised).
- Telstra CEO, Sol Trujillo — who was reported to be leaving the company with a payout of \$50 million. His termination payment was \$3 million (equivalent to one year’s base salary) (Colvin 2009).

The Australian Bankers’ Association noted that disclosure of share-based payments can ‘lead to large reported “termination payments” which are in fact merely retained bonuses not reported in the year to which they related’ (sub. 70, p. 5).

Policy-relevant considerations

The perception that termination payments are used to reward failure has some basis. Indeed, one reason that companies might choose to pay termination benefits to an executive is to encourage them to leave the company due to poor performance. While this might appear from shareholders' perspective to be undesirable — additional money being paid to a poorly performing executive — the choice for boards in these circumstances is not simply between paying an executive or not. Rather, they could face a situation of paying an executive to go quietly, or potentially facing large legal costs if the executive challenges the termination. Offering the termination payment could be the least costly option for the company in these circumstances. By enabling the company to replace an ineffective executive quickly, shareholders would benefit.

Nonetheless, the case for shareholder involvement in decisions on termination payments is stronger than for other forms of remuneration. Termination payments will not generally exhibit a clear link to performance (unless an executive can somehow influence a company's performance after departing the company). While the absence of a link to performance is not of itself objectionable (base salary, for example, is a standard feature of remuneration, yet it is not strongly associated with performance), the opaqueness of termination payments — particularly those made on an *ex gratia* basis — could threaten shareholders' interests. Moreover, although shareholders' interests could be served from boards 'buying out' a poorly performing executive, they might also question how effectively boards are designing employment contracts when termination for 'failure' could result in the company being drawn into costly litigation (notwithstanding the common law rights of individuals, which companies cannot circumvent).

Of course, remuneration packages still need to be considered in their entirety. As some inquiry participants have noted, efforts to restrain one form of pay might be expected to provoke changes to other forms. To this end, the Australian Government's changes to termination payments could lead to a restructuring of packages (such as higher base pay or a sign-on bonus), or might result in the lowered threshold becoming a new 'floor' for termination payments (box 7.20).

The argument for setting a threshold for shareholder approval of termination payments is that some benefits will be of a sufficiently low level that requiring a vote would be trivial for shareholders and excessively costly. This raises the question, how much is too much?

**Box 7.20 Consequences of reducing the cap on termination payments
— views from submissions**

Some inquiry participants noted the potential consequences from reducing the threshold for shareholder approval for termination payments. The Australian Bankers' Association stated it would 'have the effect of skewing remuneration packages towards greater reliance on base pay' (sub. 70, p. 3). Regnan noted:

Past experience with the introduction of strict regulation around executive pay in the United States has illustrated the unintended consequence of restricting a single aspect of executive remuneration; other elements of remuneration are increased to compensate for/bypass the element of remuneration that has been restricted (the 'squeeze the balloon' effect). It is therefore our concern that other elements such as base salary or sign-on bonuses may experience artificial upward pressure in response to a strict shareholder approval threshold of 12 months' base salary for termination payments. (sub. 72, attachment, p. 1)

The Australian Human Resources Institute reported that respondents to its survey of human resource managers noted that of those companies likely to be affected by the reform to termination payments, most indicated:

... it will be necessary to find some other way of spreading the present value of the forgone benefit into other remuneration elements either pre- or post-termination. Most companies have a present value income and also payment expectations when dealing with senior executives. Therefore if a regulation forbids them from operating within a certain part of the employee cost and payment curve, rational behaviour will drive them to find another delivery instrument. So the ... termination cap is likely only to solve the political perception of high termination payments at the point of termination. (sub. 49, p. 9)

CGI Glass Lewis and Guerdon Associates observed that the threshold for shareholder approval should 'not be too low as to promote unintended consequences such as an increase in base pay, sign on fees or other types of discretionary bonuses' (sub. 80, p. 60). They suggested:

... considering bringing the limit requiring shareholder approval more in line with international standards for attracting potential offshore executives. In addition, consider working with the ASX Governance Council to establish a principle for termination pay requiring a lesser maximum payment than the prescribed legal maximum on an 'if not, why not?' basis. (sub. 80, p. 101)

CGI Glass Lewis and Guerdon Associates also noted that implementing thresholds (such as that for tax penalties in the United States) can have the effect of increasing accepted practice to this threshold (sub. 80). David Peetz also acknowledged the risk that the new ceiling might become a 'floor':

The danger is that the new ceiling on termination payments, of one year's salary before shareholders' approval must be sought, may also become a floor. Consideration should be given to a lower limit. The legal minimum for termination payments set out in the *Fair Work Act 2009* is a useful benchmark. It is unclear why CEOs, whose early termination is often brought about by poor performance in the job, should receive extraordinarily generous payouts on terms vastly superior to those available to ordinary employees dismissed for the similar reasons. (sub. 50, p. 13)

Clearly, the previous threshold of seven times total remuneration allowed large payments to go through which many shareholders considered egregious (a sample is contained in box 1.2, chapter 1). However, lower thresholds — such as the current one year’s base salary — risk capturing payments that shareholders have few concerns about, imposing costs on companies (and ultimately shareholders) in terms of organising shareholder meetings. They might also motivate changes in the structure of remuneration packages.

The AICD (subs. 59 and DD149) expressed concern with the Government’s reforms, and noted that they put Australian companies at a disadvantage in the market for executives compared to those in the United States, the United Kingdom and elsewhere in Europe (box 7.17). It suggested the threshold should be changed from one year’s base pay to two times total remuneration. However, other participants supported the reduction to one year’s average annual base salary (for example, Finance Sector Union, sub. 39; Stephen Mayne, sub. 63; ACSI, sub. 71).

Regnan proposed that shareholder approval be required for termination payments greater than *twice* base salary. For payments between one and two times base salary, the company would be required to provide a justification (along the lines of the ‘if not, why not’ disclosure regime established by the ASX Corporate Governance Council), but not offer a shareholder vote (sub. 72). This could reduce the potential for perverse consequences and provide flexibility for company boards. However, it is difficult to see how such a regime could work in practice. While boards have a strong incentive to explain their reasoning for a termination payment where a binding shareholder vote is in place — such a justification could make the difference between approval or rejection — it is unclear that such incentives could be replicated by a regulatory requirement. In particular, without a shareholder vote, how could the quality of a company’s explanation be assessed? (Shareholders could vote against directors whose disclosure quality is poor, but this option already exists under the current regime where explanations are not required at all. As such, the threat of shareholders removing the board would appear to be a weak motivator on this particular issue.)

Given that the majority of contracted termination payments currently appear to be valued at between 10 and 15 months’ fixed pay, the one year threshold would seem unlikely to cause difficulties in most circumstances. However, there would be benefit in reviewing the impact of the changes at some future point.