

## SUBMISSION TO THE INQUIRY INTO THE REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION IN AUSTRALIA

### **PERSONAL EXPERIENCE**

I first bought shares in 1956 and have bought and sold shares occasionally ever since. At first shares were bought when I had spare money and sold when I needed to spend money. Later I saw share ownership, as most people do, as a way to increase wealth. More recently I have sometimes bought shares in companies that particularly interested me, or as an indirect contribution to research. I have held shares both long term and short term, but have not been a 'day trader'. I have bought shares in about 140 different companies. Becoming knowledgeable about many companies and following their fortunes has been a continuing interest for me.

Over the years I have become increasingly unhappy about the growth of director and executive salaries relative to the earnings of most other community groups, including shareholders. I have been sadly disappointed that financial journalists have accepted, or even supported, the growing culture of executive greed. I have despaired at the impotence of individual shareholders to encourage companies to resist executive remuneration demands, or to influence major decisions affecting companies' futures.

Either my wife or myself has been a member of the Australian Shareholders Association (ASA) since 1995. I have corresponded with the directors on many aspects of the work of the ASA. The ASA has done much to further shareholders' interests, but there are severe limits to its influence.

I much welcome the Inquiry and the opportunity to make a submission to it. I look forward to real reform as a result of the work of the Inquiry Commissioners and staff.

### **EXECUTIVE REMUNERATION**

#### **Problems**

1. The upper levels are unfairly high.

The annual income of more than 90% of Australians is less than \$65,000. They include people in a wide range of occupations, including teachers, nurses, tradesmen, clerks, shop assistants and unskilled workers. They are employed in every industry – health, education, manufacturing, retail, agriculture, building, government and many others. By and large they work well and perform valuable functions. By contrast, a small proportion of people, notably high level industry executives, receive annual remuneration from 15 times to more than 100 times the general income level. The general perception is that this is simply unfair.

If there is a case for executives to receive more remuneration in one year than most people receive in a lifetime, the onus should be on executives to demonstrate that they deserve and need this level of income. The onus should not be on shareholders, or anyone else, to demonstrate that the executives do not deserve very high remuneration.

2. The upper levels are not set openly.

The wages and salaries levels of most people has stemmed from a transparent process relating to industry awards, open negotiation, government pay scales and a concept that the acquisition of additional knowledge or skills should be rewarded, but by a relatively small percentage above the earnings of those less skilled. Increases in wages are almost always openly opposed by employer representatives.

Upper levels of executive remuneration are set without any reference to other wage or salary levels. They are not the result of a transparent process. They are not opposed openly by any representative group.

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3. The upper levels are not set fairly.

Executive levels are set by other executives, company directors and remuneration consultants. The earnings of all those involved are broadly related. There is no little or no incentive for any of the participants to oppose either high levels of remuneration, or increases in existing remuneration levels.

4. Executive remuneration is too complex.

When a new company is formed the first approvals sought from shareholders usually involve financial inducements to directors and executives. A new senior appointment usually involves lengthy negotiation over various aspects of financial rewards. At most Annual General Meetings there are proposals for increasing executive remuneration or inducements. Shareholders can reasonably deduce that a substantial proportion of the time and energy of many senior executives are directed towards arrangements for enhancing their own financial rewards and prospects.

Executive remuneration usually involves several components, which may include salary, shares, options, bonuses, loans and allowances. These components can be structured in various ways and may be tied in various ways to short and long term targets. It is very difficult for shareholders to properly understand the arrangements and to assess the implications, particularly longer term, regarding the total remuneration of an executive.

A large proportion of employed Australians simply receive a wage or salary. They occasionally share in a broad based increase in wages or salaries. In some cases, if they have performed well in one year they are paid rather more the next year.

If a simple payment structure is suitable to encourage most employed people to work diligently and effectively and in the interests of their employers, it is difficult to see why highly paid executives need a highly structured remuneration system to encourage them to work diligently and effectively and to align their interests with those of shareholders, who are really the owners of their companies and, effectively, their employers.

5 Money is an ineffective motivator.

Many studies have shown that, at higher remuneration levels, financial rewards, as such, are not a strong motivator for executives. Even so, while motivation is important, it is not the same as achieving results. The relationship between higher remuneration and results would be even weaker than the relationship between higher remuneration and motivation.

Research shows that the primary executive motivators are achievement, recognition, prestige, self esteem, autonomy and power. High remuneration is sought, however, because it is the most obvious measure and demonstration of achievement and it is important to self esteem. Executives seek remuneration at least comparable to others in similar positions. Competitiveness is a common executive attribute, so there is further motivation for executives to seek better than comparable remuneration.

Shareholders are most frequently informed of additions to remuneration, rather than remuneration arrangements at the beginning or the end of the employment of particular executives. So when shareholders are invited to vote on a remuneration proposal they are usually voting on an incremental change in remuneration. There seems to be little published research on the motivational effects of incremental changes in remuneration or remuneration prospects, but they are likely to be marginal, at most.

6. The upper levels largely determine the whole executive remuneration structure.

People are strongly influenced by their perception of fairness concerning remuneration. Executives have a good appreciation of the competence, diligence and effectiveness of the next higher level of

executives in the companies in which they work. They press opportunistically to achieve a remuneration level that they consider has a fair relationship to that of their superiors, so there is a step function in the salary levels of executives in most companies. If the upper levels are unduly high, the total executive cost becomes unduly high. If there isn't a step structure, lower level executives become dissatisfied and probably less effective.

#### 7. Executive cost is not insignificant.

The cost of personnel is a significant part of the cost of most companies, as is well demonstrated by the almost universal resistance of wage claims by industry representatives. Contradictory, it is not argued that a lesser wage level will lead to workers becoming less productive. It is as valid for shareholders to resist executive remuneration claims as it is for management to resist wage claims. The argument that executive remuneration is a small component of company costs, so shareholders are not disadvantaged by high remuneration levels, is not persuasive. In many small companies executive remuneration is a substantial proportion of company costs and is not a lot less than dividend payments.

#### 8. Remuneration arrangements cover only increases, not reductions or penalties.

The whole structure of remuneration arrangements is concerned with payments and rewards of various kinds. Despite their complexity, remuneration arrangements only provide for increases in remuneration. No provision is made for remuneration to decrease if the measures which are linked to increased remuneration go down. Remuneration arrangements never refer to penalties for improper behaviour, poor performance or bad decisions. Even the Productivity Commission Issues Paper makes no reference to the possibilities of reducing remuneration, or to penalties. Avoiding consideration of remuneration reductions or penalties would be irrational, particularly now that there is public outrage about remuneration rewards to directors and executives who have been substantially responsible for partial or complete failure of companies, for companies needing government financial support and for company decisions which have been reckless or otherwise seriously unwise.

While the loss of some anticipated future benefit from a component of a remuneration arrangement is, in some sense, a penalty, it is in a different category of penalty to a reduction in salary, repayment of a bonus, or withdrawal of options. Although boards can terminate an executive appointment, this seems to be a very rare event and, even so, there is wide scope for payouts and the details of these are seldom made public.

#### 9. Shareholder involvement with executive remuneration is ineffective and biased.

Shareholders currently can only vote on the allocation of shares to directors, total director fees and above threshold termination payments. They have a non binding vote on remuneration reports and theoretically could vote on director remuneration which is not "reasonable".

A remuneration report usually covers several aspects of remuneration. The opportunity to simply vote for or against a whole report is only a crude measure of support or opposition. Experience has demonstrated that non binding votes have little effect. In any case voting is biased. Most shares are held by institutions and the individuals responsible for the votes are themselves high level executives, with remuneration broadly related to company executives, so they have little incentive to oppose high levels of executive remuneration in companies.

### **Misconceptions**

#### 1. Executive remuneration is competitive.

Executives are mostly appointed internally or through recruitment agencies. The emphasis is on selecting the most suitable person, then negotiating remuneration. The process and the results would be quite different if a number of suitable candidates were identified, their minimum acceptable remuneration was established, then an appointment was made taking account of both personal attributes and the remuneration acceptable to individual candidates. So executive remuneration is not really competitive.

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2. Executive remuneration should match internationally.

High remuneration advocates argue that Australian executive remuneration should be at similar levels to other countries. The USA has often been quoted as the yardstick, or the USA, England and Canada. Notably, the comparison is not made with western European countries, eastern European countries, Japan, Korea, Japan, Indonesia, Malaysia, or any South American country.

Australian executive positions are seldom advertised internationally and recruitment agencies only narrowly canvas internationally, at best. The result is that the proportion of international executive appointees is quite small, other than for a few executives transferred between branches of international companies. There is no evidence of a shortage of Australian executives and there is no evidence that large numbers of Australian executives are attracted by higher remuneration elsewhere. So international remuneration levels are largely irrelevant to an appropriate setting of Australian executive remuneration levels.

3. There is an international market place for executives.

It has been argued that there is an international market place for a limited pool of talented and mobile executives. There are highly competent executives in all countries. Many would be glad to work in Australia if they had the opportunity. To argue to the contrary is beyond belief. Very few Australian executives have been recruited, however, in countries other than the USA and Britain.

Possibly it would be advantageous if a significant number of executives were recruited from a number of other countries. It might be argued that few executives have been recruited from other countries because they would not be familiar with Australian conditions. There seems to be little evidence to support such an assumption. If the lack of familiarity argument were true, however, it would also be true regarding the suitability of Australian executives for employment in other countries, adding further support for the conclusion that there is no need for Australian executive remuneration to be comparable internationally. So it is a gross over exaggeration to state that there is an international market place for executives.

4. High remuneration is a high motivator.

Research has generally shown quite clearly that high remuneration is not a high motivator for executives and that increasing remuneration is largely ineffective. In communications with shareholders, companies commonly state that specified levels of remuneration and various aspects of remuneration are necessary for executives to align their interests with those of shareholders. Common experience would lead most people to conclude that if an executive is being paid half a million dollars or more a year in salary, that alone should ensure that the executive did their best for the company and shareholders. Any less would hardly be honest. It is incorrect and misleading to claim that high remuneration is a high motivator.

5. Company success and shareholder rewards are directly related to the level of executive remuneration.

Seldom a business day passes without evidence in the financial press that highly paid executives have made decisions that have markedly disadvantaged shareholders' financial interests. It seems as likely that executive rewards are causally related to company size and earnings as that company size and earnings are causally related to executive rewards.

There seems to be no persuasive research evidence that company success and shareholder rewards are directly related to the level of executive remuneration or executives' prospects for future remuneration.

6. Critics of high executive remuneration are motivated by envy.

It has often been stated that the opposition to high executive rewards is "the policy of envy" and opponents have been denigrated in various ways. Rebuttal of this kind of attack by an Australian financial writer has been rare indeed. On the contrary, until recently Australian financial commentators

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have almost universally accepted, without question, director and executive statements in support of high remuneration.

Australians are not generally envious of success, or high rewards, within limits. But most Australians have a fundamental commitment to “a policy of fairness”.

## 7. Effects of high taxation.

Suggestions have been made that a steeply rising tax structure, or even a prohibitively high top rate, would exercise a strong restraining influence on executive salaries. This may be correct and possibly there is a more general case for a more progressive tax scale. In itself, however, the payment of more tax by executives to government would have no direct benefit to shareholders.

## 8. Disclosure of information.

While measures to improve the disclosure of information to shareholders would be helpful in a general sense, more information is of limited practical value to shareholders unless they are able to take positive action in response to the information.

## **Suggestions**

### 1. Culture

More restraints on executive and director remuneration are needed. However the problems are too entrenched to be overcome by limited modifications to the existing legislative and supervisory arrangements. Excessive remuneration is largely a cultural problem. The culture of greed needs to be modified by a culture of fairness. This can only be achieved through changes in the way governments, supervisory agencies, shareholders, directors, executives and financial journalists perceive their roles and the way they act. It will not occur naturally, but should be encouraged deliberately and comprehensively.

- . The Inquiry could contribute towards a fairer culture through progressively publicising its work.
- . The Inquiry report should stress the need for cultural change and should recommend measures to encourage cultural change.

### 2. Research

The whole complex structure of executive remuneration rests on unproven assumptions about the effects of high remuneration and various components of remuneration on executive effectiveness.

- . The Inquiry should conduct a wide ranging review of research findings about the actual effects of remuneration levels, various remuneration components and marginal increases in remuneration on executive motivation and effectiveness.
- . As far as practicable the Inquiry should commission research to improve knowledge of relationships, if any, between executive remuneration and effectiveness, based on Australian experience.
- . The Inquiry should recommend that new research be undertaken to improve knowledge of possible relationships between executive remuneration, motivation and effectiveness in Australia. The Inquiry recommendations should provide guidance on funding, research institutions and commissioning agencies.

### 3. Publicity

- . The report of the Inquiry should include a comparative table of director and executive remuneration in the top twenty countries ranked by average income.
- . The Inquiry should recommend that information about important aspects of director and executive remuneration be collected systematically and published regularly by the Australian Bureau of Statistics.

## 6.

- . The Inquiry should recommend that the Productivity Commission publish an annual Director and Senior Executive Remuneration Guide, showing a suggested range of figures for various executive levels in companies grouped by industry, size and recent rate of growth in earnings per share.

### 4. Remuneration complexity

- . The Inquiry should investigate executive arrangements in a wide range of other countries to determine whether there are simpler and at least equally effective remuneration arrangements as those which commonly apply in Australia.
- . In formulating recommendations relating to more effective regulation of executor and director remuneration the Inquiry should give particular attention to the merit of reducing the complexity of remuneration arrangements.

### 5. Shareholder Involvement

The Inquiry should recommend the following.

- . Voting on remuneration reports should be structured so that the important components are voted on independently.
- . For all voting on executive or director remuneration, both the number of shares voted and the number of shareholders who voted should be recorded.
- . Shareholders should be given the opportunity to vote on as many individual aspects of director and executive remuneration as practicable. The Inquiry should recommend the aspects of remuneration that should be subject to shareholder vote.
- . A remuneration report or any other aspect of remuneration taken to a vote should not be implemented if more than 50% of the votes, or more than 75% of voting shareholders oppose it.
- . In formulating recommendations relating to shareholder involvement the Inquiry should not make special arrangements for institutional shareholders which would give them advantageous standing or influence relative to that of individual shareholders.
- . Remuneration arrangements should include provisions for remuneration to decrease as well as to increase in response to changes in linked indicators.
- . Remuneration arrangements should include provisions that take account of possible cases of executives making seriously bad decisions.

## **DIRECTORS**

### **Concerns**

Directors generally have encouraged, rather than discouraged, the high growth in executive remuneration. There are few, if any, public records of directors opposing any of the high remuneration arrangements which have attracted strong public criticism.

Director remuneration is high relative to average salaries and has increased at much higher rates.

It is almost impossible for shareholders to assess the appropriateness of director remuneration because directors have only a part time involvement with a company and, in many cases, are also directors of other companies. Some are also employed in high level and, presumably, demanding executive positions. The total earnings of directors from multiple directorships may be very substantial.

The number of directorships held by many individual Australian directors indicates that there is an element of exclusiveness associated with the selection and appointment processes.

Many companies have not adopted ASX recommendations against directors receiving options, bonus payments or retirement benefits other than superannuation.

Boards of directors generally give shareholders the impression that they are allies of the executives, rather than representatives of the interests of the shareholders of companies. Some Chairmen are resistant to the expression of shareholder expression at Annual General Meetings (AGMs).

## **Suggestions**

The Inquiry should recommend the following.

- . The number of directorships be limited to four for an independent director and one for a director who is an executive director of another company.
- . Remuneration reports should include the names of any other directorships currently held by each director.
- . The ASX recommendations against directors receiving options, bonus payments or retirement benefits other than superannuation should be mandatory.

## **SHAREHOLDER INVOLVEMENT**

### **Concerns**

The terms of reference of the Inquiry do not specify consideration of shareholder involvement in company management, other than in relation to director and executive remuneration. Many shareholders consider, however, that while remuneration issues are important, even more disturbing have been the disastrous decisions made by managers of previously well founded companies which have led to huge losses of equity and, in some cases, to company failures. Bad management decisions have been brought more prominently to public notice in recent times and there have been more spectacular failures than normal, however there is a long history of disastrous management decisions. In many of these cases, reasonably knowledgeable shareholders have felt concerned that the management decisions conflicted with previous experience, or were unduly risky in relation to possible future benefits. Some of these decisions were widely criticised by financial commentators at the time.

Shareholders are the owners of public companies and it seems only reasonable that they be offered a role in connection with decisions which involve huge expenditures, high levels of debt, major changes in company structure, major changes in company activities or costly new enterprises, any of which might lead to serious loss of equity, or even company failure.

It has sometimes been stated that shareholders should leave the management of their companies to the directors and executives and that if a shareholder is not happy with the way a company is managed they should sell their shares. This advice defies common sense. If a shareholder invests in a company because the business is well founded, the earnings are good and there are sound prospects for good earnings to continue, then the managers decide to restructure the company, lead it in a substantially different direction, or undertake a major expansion, shareholders should be carefully informed and consulted before the change, rather than that the managers just deciding as they choose and expecting any shareholder who does not agree with the decision either to accept it, or sell their shares.

Although institutional representatives and the ASA have some access to members of boards and senior executives during the year, there is little opportunity for most individual shareholders to present a viewpoint other than at AGMs. Even for shareholders who are able to attend, AGMs only offer a limited opportunity to present a viewpoint on agenda items. They provide little opportunity for presenting views on earlier company decisions and virtually no opportunity for views on future directions for companies.

Many of the major decisions made by company managers involve issues of confidentiality or timing, so consultation with shareholders may be difficult, or impossible, to arrange. On the other hand, shareholders now vote on some issues, particularly relating to takeovers, and there seems to be no serious impediment to shareholder consultation prior to other kinds of decisions. Email access is now almost universal and email is widely used for communications from companies to shareholders. Companies could now poll shareholders on any issue quickly and at low cost. Polls before proposed major changes in company structure and major changes in company direction could be made either optional or mandatory. Company responses to the results of polls could be made optional, conditional or mandatory.

One of the most important outcomes which could emerge from recent disastrous financial experiences is the once in a lifetime opportunity for shareholders to achieve a reasonable level of influence in the

direction of the companies they own. The current financial crisis will pass in due course. All the management and financial flaws that have been associated with it will be soon forgotten and all the types of participants who benefited from the flaws which led to the financial crisis will return to acting the same roles again. The current broad public support for reform and government willingness to take reforming action is unlikely to persist in more favourable economic circumstances.

### **Suggestions**

- . The Inquiry should consider shareholder involvement in company management other than directly in relation to remuneration, as far as possible under its terms of reference and within its current time and resource constraints.
- . If feasible under its terms of reference, the Inquiry should consider and report on the possibilities of companies using email polls to obtain an indication of shareholder opinion before decisions are made which involve very large expenditures, high levels of debt, major changes in company structure, major changes in company activities or costly new enterprises.
- . If the broader subject of shareholder involvement cannot be adequately considered at this time, the Inquiry should recommend that, after completion of the current Inquiry, it should continue to work and then report separately on shareholder involvement in company management.
- . The Inquiry should recommend that each of the AXA100 companies be asked to consider the appointment of a Shareholders Director, with a defined and constrained access to company information and a defined and constrained participation in board meetings, but with a role of communicating with shareholders, presenting shareholder views at board meetings and reporting in annual reports and at AGMs.