Graham Bradley

20 May 2009

Executive Remuneration Inquiry
Productivity Commission
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Dear Sirs,

Submission to Executive Remuneration Inquiry

I make the following short submission in response to the Issues Paper of April 2009.

This submission does not seek to respond to all questions raised in the Issues Paper. Rather, I wish to set out some of the reasons why the Commission should find that there is no case for further regulatory controls over the authority of public company boards to determine appropriate executive remuneration policies and levels, which it is their proper function to manage and control.

I make this submission in my personal capacity. I do so based on my experience and credentials as a public company chairman and director. That experience includes the following:

- Experience for 13 years as a public company director, including eight years as an executive director and chief executive officer of Perpetual Trustees Australia Limited.
- Five years experience as a full-time company chairman and director which includes my current roles as chairman of top 50 ASX listed Stockland Corporation Limited, chairman of Boart Longyear Limited and Po Valley Energy Limited, both ASX listed companies, together with my directorship of the ASX listed Singapore Telecommunications Limited, which is also the largest listed company in Singapore.
- My experience for over 10 years of service as a director of government enterprises (chairman Film Finance Corporation Australia 2004-2008), member-owned organisations (director MBF Limited 2004-2007) and numerous non-profit organisations, including Garvan Research Foundation (chairman 1999-2009), Garvan Institute of Medical Research (director 1999-2009) and currently as a director of the Australian Brandenburg Orchestra and State Library of NSW Council.

Threshold Concerns

I have several threshold concerns regarding the issues before the Commission and the thrust of the questions set out in Issues Paper.

First, the Commission should consider carefully the public policy rationale for singling out the remuneration of executives and directors of public companies (that is, disclosing entities) for specific restrictive regulation. Doing so would create an unlevel playing field between public companies and other business and community organisations of equal importance to Australian society, such as private corporations, mutual associations and co-operatives, unlisted trusts and professional partnerships. The Issues Paper does not ask why the same laws in relation to executive and director remuneration should not apply to all such organisations equally. If, for example, a special tax were to be imposed on bonuses paid to company executives, why as a matter of public policy would not a similar tax be imposed upon executives of private companies, mutuals, etc? Imposing special regulations for public company remuneration would potentially discourage business enterprises from becoming listed entities, thereby reducing the available investment opportunities for Australian investors. Why should public companies be treated differently? If the case for special treatment were based on the view that they are important institutions in which Australians invest their retirement savings, then similar concerns about the structure, level and risk-taking incentive consequences of executive remuneration should be extended not only to unlisted enterprises, but also to individuals who perform the roles of fund managers, asset consultants and others who significantly direct and influence the investment of the larger part of Australians' retirement savings.

Second, the Commission should consider whether, by imposing constraints (and possibly special taxes) on director and executive remuneration that do not apply in other capital markets, we potentially reduce the attractiveness of listing in Australia for companies that have a choice of jurisdiction. For example, I am chairman of two ASX listed companies—Boart Longyear Limited and Po Valley Energy Limited—both of which in the past five years chose to list in Australia but could have listed elsewhere. In the case of Boart Longyear (a global mining drilling company), less than 20 percent of the company's business is Australian-based, and the company's operational headquarters are in Salt Lake City, Utah. It could have listed in North America, Europe or Australia. Similarly, Po Valley Energy is a gas and oil exploration and development company whose operations are entirely based in Italy. Its operational headquarters are in Rome. It, too, could have chosen to list in the UK, Europe or North America. Both companies chose to list in Australia in part because of the credibility with international investors of our listed market, our disclosure-based corporate governance regime, and our corporate laws and regulation. Controls over executive remuneration beyond those applying in other jurisdictions would, I believe, be a competitive disadvantage and a possible deterrent for organisations when deciding whether to list in Australia, to the detriment of the size and liquidity of our local stock market and the disadvantage of Australian investors.

Third, it is important for the Commission to appreciate that the remuneration packages reported for Australian executives in company remuneration reports in many cases do not reflect the actual values of those packages in practice. Because remuneration reports are required to be audited, share-based benefits are reported in "fair value" terms determined under accounting conventions. In many cases, reported conditional remuneration may not fully vest or may be worth substantially less than the reported amounts when they vest. For example, a large listed company of which I am chairman, reported a long-term incentive award to its CEO of $1.3 million in its 2007 Remuneration Report. This potential share-based incentive was performance-based and measured over a three year period. Two years later, in 2009, the likely value of this award is less than $0.4 million since only 25 percent of the incentive is likely to vest and the company's share price has declined since 2007. The actual outcomes of "at risk" remuneration are not required to be reported under the Corporations Law as it now stands. It is important, therefore, that the Commission notes that, in many cases, the reported value of remuneration packages may be significantly overstated in remuneration reports as a result of the applicable accounting rules.

Finally, many of the questions posed in the Issues Paper do not seem to be founded on an informed understanding of the role performed by public company boards in contemporary Australian corporate governance practice. For example:

- *What are the key drivers of performance of directors and executives? Are there factors other than remuneration that influence their performance?*

  This very question seems to assume that there is little distinction between the roles, responsibilities, performance and motivation of company directors on the one hand and executives on the other. In fact, there are significant distinctions between the roles of directors and executives, completely different legal liabilities and responsibilities, and fundamentally different structures of remuneration.

- *Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director and executive behaviour inconsistent with the interests of the company?*

  Again, this question pays little heed to the distinct roles performed by directors and executives in the corporate decision-making process. In practice, all significant decisions made by executive management are either approved by the board or made under delegations of authority approved by the board within a framework of corporate policies and budgets set by the board. The question seems to ignore the fact that, under the corporate governance principles adopted by the great majority of Australian public companies, director compensation is fixed from year-to-year, does not vary with company performance, whether short-term or long-term, and neither encourages nor discourages risk-taking.

- *Can cost-cutting by companies, including by sacking workers, align with the public interest? Is it reasonable to reward executives for actions that promote shareholder interests, but which may not align with the public interest?*

  These questions suggest a misunderstanding of the reasons why shareholders invest in business corporations. They do so to generate a profitable return on their investment and they therefore expect both the board and management to conduct the business of the company so as to create sustainable returns over time, by providing valuable products and services to the company's customers and operating the company in compliance with all applicable laws, in an ethical and responsible manner. Business corporations do not exist to fulfil community service obligations or other "public interests". Just as government departments and non-profit organisations must at times cut costs, including by sacking workers, to fulfil their statutory or constitutional objectives, so must business enterprises. These questions betray confusion between the purpose of business enterprises and other sorts of organisations.

Accountability for Executive Remuneration should lie with the Board

In my submission, the Commission should avoid recommendations which undermine the principle of board accountability which has been fundamental to both corporate law and business practice for the past 150 years, namely, that the business owners (shareholders) elect directors who are then responsible for managing the assets and affairs of the company to achieve the shareholders' objectives, and are answerable to shareholders for their performance in doing so. It is my submission that:

1. Control of executive remuneration is fundamental to board accountability.
2. The accountability of boards for responsible management of executive remuneration works well under the current regulatory regime.
3. Inappropriate regulatory constraint on the authority of boards to manage executive remuneration runs the risk of undermining the fundamental accountability of directors to shareholder.

I will address each of these points in turn.

1. **Control of Remuneration is Fundamental to Board Accountability**

It is a basic tenet of our Corporations Law that boards answer to the shareholders who elect them for all aspects of the performance of the company and for the honest, diligent and faithful exercise of their responsibilities as directors. Boards of directors must have the authority to appoint executives whom they believe have the skills, experience and personal leadership qualities necessary for the business' success. Most directors would agree that their single most important decision is the appointment of a chief executive officer, closely followed by their approval of key executives reporting to the CEO. When appointing executives, in my experience, boards carefully weigh up the skills, experience and calibre of candidates against the compensation package necessary to attract the best individuals. It is rare in the competitive marketplace for executive talent that the better candidates do not come at a higher price. Boards must, therefore, make a "price versus quality" trade-off, and be accountable for the results. If the board's authority to negotiate remuneration packages and structures is constrained artificially by regulatory limits, the board is placed in the invidious position of having responsibility for the outcome (the company's business performance) but no authority to select the best agents to manage the company's affairs to achieve the best performance.

2. **Board Accountability Works Well**

In my experience, public company boards take their responsibility for setting fair, competitive and reasonable remuneration very seriously. It is almost universal practice now for boards to have remuneration sub-committees to provide focussed attention on the many complex issues that must be considered by boards in structuring effective remuneration policies, setting performance hurdles and objectives, assessing performance against those hurdles and ultimately recommending to boards appropriate remuneration levels and arrangements. It is not unusual nowadays for the work of the Remuneration Committee to be every bit as time-consuming and demanding as the work of company's Audit Committee.

The ASX Corporate Governance Principles, the Corporations Law and current corporate practice now require a high degree of disclosure in relation to executive remuneration. Directors are routinely questioned on remuneration matters by institutional investors and, at annual general meetings, by retail investors. As a public-company chairman, I often seek direct comment from major shareholders on remuneration policies and I regularly take soundings on remuneration policies from governance advisory groups, such as the Australian Shareholders Association and proxy advisory firms. Equity-based compensation that involves issuing securities to executive directors must be directly approved by shareholder votes. In recent years, there are numerous examples of such arrangements being voted down or withdrawn as a result of adverse proxy voting or feedback from investors.

Accordingly, it is my submission that the current disclosure and regulatory regimes are effective in underscoring the accountability of directors for executive remuneration. I also submit that there have been very few cases in Australia of conspicuously unreasonable or excessive remuneration arrangements compared to those widely publicised in other countries. It is also important for the Commission to appreciate that, while this is not universally the case, the great majority of senior executive remuneration structures that have been adopted by public companies in recent years are "self-adjusting" in that the value of packages is significantly diminished in periods when markets and stock prices are low. Typically a high proportion of packages are now "at risk" and tied in one way or another to market and share price performance. (I have earlier commented on the danger of assuming that the "value" of executive remuneration packages as reported truly reflect the rewards ultimately paid under these arrangements.)

3. **Regulatory Control of Remuneration undermines Board Accountability**

Boards cannot be held properly accountable for company performance unless they are able to hire, fire and set remuneration for their chosen senior executives. It is important to maintain the board's discretion in relation to remuneration since the circumstances of individual companies will vary greatly, one from another, and will differ over time, depending on the company's financial and business circumstances.

The current regulatory regime requires more than ample disclosure to ensure that boards feel and are, in fact, answerable to shareholders for their decisions for their executive remuneration decisions. Moreover, shareholders must vote on equity-based pay (where this is dilutive) for executive directors. The non-binding vote to adopt the Remuneration Report provides ample opportunity for shareholders to voice their views on the board's remuneration decisions. I am firmly opposed to the introduction of binding votes on remuneration reports. Remuneration reports are typically voluminous, and it would be unreasonable for a company's entire remuneration regime to be put in doubt should shareholders vote against the report because of one single element of the company's remuneration policy. Also, it is my view that compulsory voting on remuneration reports could well attract protest votes unrelated to remuneration, inappropriately causing harm, uncertainty and expense for companies.

Summary

In summary, based on my years of experience as a public company director and chairman, I do not believe that there are any fundamental weaknesses in the current legal and regulatory regime governing the authority of boards to set and be accountable for executive remuneration. I do not believe that additional regulatory constraints are necessary or desirable. My views are more fully set out in the attached article which was published by the Australian Financial Review on 16 April 2009.

Yours sincerely,

Graham Bradley

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Boards should hold sway over executive pay

Heavy handed regulation of executive pay would undermine the authority of directors to align compensation to the interests of shareholders, writes Graham Bradley.

Understandably, governments around the world have reacted to public outrage over excessive executive remuneration, with several different proposals to constrain executive pay in developed countries already aired.

The federal government proposes to restrict payments when executives leave or retire. Legislators should not lose sight of the fact that many factors are involved in setting sound executive pay policies. These differ markedly, depending on the industry and company. To provide an effective solution, any regulatory prescriptions would need to allow a range of outcomes. Otherwise, they may well exacerbate the problem.

Many experienced company directors believe that past "reforms" in Australia aimed at providing greater disclosure of pay for our highest paid public company executives contributed to inflation of executive packages over the past decade. Disclosing pay in annual reports has, in practice, increased the bargaining leverage of executives, making it harder for boards to negotiate pay. Moreover, accounting rules often overstate the value of packages, including share allocations that may never be awarded.

Determining compensation is complex in any company. A large range of fairness, relativity and competitive market considerations come into play, as well as present and future circumstances of individual organisations.

Most would agree that the boom of recent years led to some flagrant examples of badly designed compensation schemes that contributed to poor management decisions and, arguably, worsened the inevitable global financial correction. Quite properly, there is universal condemnation of arrangements that have rewarded executive failure. It is fair to say that far fewer such cases occurred in Australia than elsewhere.

Boards in Australia should, and I believe will, use the changed economic conditions to review and, where necessary, reform their organisations' remuneration policies. Indeed, they have a responsibility to do so. Even remuneration models that seemed to work well in the long bull market may be wrong for more volatile and less buoyant times.

In this regard, public company boards in Australia have not been as slow on the uptake as it appears some of their counterparts have been in the United States.

For example, boards and executives in future may well be more circumspect about the proportion of pay taken in the form of shares. Additionally, in the current slump, many existing remuneration schemes that require issuing large numbers of shares risk giving huge future gains to executives when markets improve – gains that will be due more to market sentiment than to executive performance. These need to be redesigned

The risk of windfall gains has fuelled debate about imposing caps on bonuses, even for share-based incentives. It is, however, inherently illogical to cap equity-based compensation as this is supposed to allow executives to share both the rewards and the risks of share prices along with other shareholders.

The better approach is to ensure executive contracts and pay schemes retain discretion for boards to adjust compensation as conditions change so that, over time, pay and incentives remain aligned with the interests of shareholders.

Badly designed schemes contributed to poor management decisions.

It would be a major setback to good corporate governance if the authority of boards to address these issues, in the circumstances of individual companies, were weakened rather than strengthened through piecemeal regulation.

In the early 2000s, Australia avoided the problems experienced by US corporations arising from the Sarbanes-Oxley, black-letter law approach to governance laws adopted all too quickly in reaction to the corporate malfeasances of the late 1990s. The disclosure-based, "if not why not" approach embodied in our own 2003 ASX Corporate Governance Council's Principles has, by contrast, worked well.

New regulation, if any is needed at all, should aim to reinforce the authority of boards to manage pay issues sensibly, in the interests of all stakeholders, rather than mandate strict rules. Mandatory rules must inevitably be arbitrary and cannot take individual company circumstances into account.

I believe that responsible public company directors in this country recognise that now is the time to review pay policies and take remedial action to re-align the interests of all stakeholders when setting pay policies.

Many remuneration committees are well advanced in this task.

The Australian Institute of Company Directors (AICD) recently published guidelines on executive pay, setting out some useful suggestions to assist boards.

Central to the AICD's approach is that boards need to take full control of the executive remuneration setting process.

The AICD recognises there is no silver bullet or one-size-fits-all approach that will suit all, or even most, companies.

One thing I hope to see come out of the current review is less short-termism, in both business strategies and investor expectations. Incessant focus by analysts on short-term results has led inevitably to overly short-term incentives being built into some remuneration packages in recent years. Compensation arrangements should reward sustainable, bottom-line profit and return on capital rather than purely short-term revenue generation.

Criticism from institutional shareholders has, I believe, led many companies to adopt only a narrow range of remuneration structures. Remuneration consultants have tended to follow the herd in this regard. Ill-considered regulation could have the unwanted effect of further institutionalising inappropriate approaches.

Boards must reassert their proper role when exercising judgment and discretion in the design and implementation of executive pay.

Lawmakers should be wary of imposing arbitrary strictures on the authority of boards to design compensation structures that are truly adapted to the contemporary needs of their companies.

■ *Graham Bradley is a professional company director and chairman. His boards include Stockland, SingTel, HSBC Bank Australia and Boart Longyear.*

AFR 16/4/09

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