28 May 2009

Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2
Collins Street East
MELBOURNE VIC 8003

Dear Commissioners,

Re: Regulation of Director and Executive Remuneration in Australia

The Australian Chamber of Commerce and Industry (ACCI) and its members consider the Productivity Commission's (the Commission) inquiry into executive remuneration in corporate Australia as a significant public policy debate.

Through our membership, ACCI represents over 350,000 businesses nationwide, including over 280,000 enterprises employing less than 20 people, over 55,000 enterprises employing between 20-100 people and the top 100 companies.

ACCI confirms that it would be pleased to participate in the Commission's inquiry by providing a formal written response that will constructively engage with the Commission's draft report (due September 2009), and respond in detail to any preliminary findings and draft recommendations.

We note that simultaneous inquiries are also being held by APRA, the Parliamentary Joint Committee on Corporations and Financial Services and Australia's Future Tax System Review which will, in addition to the current Commission's inquiry, consider related issues.

ACCI released a public statement on the issue on 18 March, in which we articulated industry's view on the issue:

> [ACCI] has cautioned against decisions on the regulation of executive remuneration in Australia being made in the hotbed atmosphere of understandable community sentiment against the corporate excesses in the United States that gave rise to the global economic crisis.

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Australian business owners and managers, many of whom work hard for only modest returns (especially in small business), share in that community sentiment, and are on the receiving end of the economic downturn.

However, executive remuneration is not an area that naturally lends itself to regulation by the state, and proposals need to be considered in an objective manner lest they be counterproductive. There is considerable risk with government regulating private reward especially in an economy like Australia's that needs to be internationally competitive, no matter how imperfect the private sector or individuals may be.

The review announced today by the government needs to recognise the limits of what the state can and should do in this area, and focus its attention on the appropriate duties and role of directors and shareholders, and the adequacy of existing accountability structures.

It is within that prism that ACCI and its members will address the Commission's inquiry on executive remuneration. Whilst we will not be submitting a formal submission until the exposure draft is released, there are, however, a number of important preliminary and broad policy principles (attached) that will guide ACCI and its members' consideration of such matters. These industry principles on executive remuneration will be further refined and articulated by industry when it responds to any detailed findings or proposals in the Commission's draft report.

These preliminary principles on executive remuneration are without prejudice to the views of ACCI or its members and may undergo further consideration and development.

On a related matter, as part of the Commission's brief will consider *"the role of, and regulatory regime governing, termination benefits"*, ACCI considers that it would be premature for the Government to progress the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* before all of the issues have been traversed in this inquiry. For the information of this inquiry, we have not therefore engaged with the detail of the Government's exposure draft legislation at this stage.

We would be pleased to discuss the above matters in conference prior to the release of the draft report and at a mutually convenient time.

If you require further information please contact Mr Daniel Mammone (daniel.mammone@acci.asn.au) Manager - Workplace Relations & Legal Affairs, in ACCI's Melbourne office on (03) 9668 9950.

Yours sincerely,

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ACCI Principles on Executive Remuneration
(May 2009 – PC Inquiry into Executive Remuneration)

1. Regulatory vs Non-regulatory: The inquiry should be cautious of only focusing on regulatory response measures. Whilst we have all recently witnessed excesses here and abroad, which are above and beyond the community's expectations, this is more the exception than the rule for most companies. It has also taken place in an unusually long expansionary period of growth. At the same time, we also have witnessed the market self-regulate to a certain extent, with numerous examples of firms and executives announcing "wage freezes" and recalibration of remuneration packages.[1]

Some commentators have also suggested that there is an element of self correction in executive pay. Michael Robinson, co-founder and director of equity firm Guerdon Associates, stated that executive salaries were "definitely on the way down":

> The expectation is that during an economic downturn executive pay may decrease. In 1991-92, we saw executive pay actually decrease, and that was quite a severe change.
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> When things are good, it certainly executive remuneration outpaces growth in regular pay-packets, but in the not-so-good times it decreases, which doesn't usually happen in other sectors. You get swings and roundabouts with executive pay that you don't get with regular workers' pay.
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> We expect a slowdown and not much growth. That happened in the 1990s and 1980s and also in the late 1970s. Pay did go backwards, and that will happen again.[2]

Whilst some recent examples outlined in the media do provoke legitimate concern amongst the community, any response should be appropriate, well-measured and balanced. In other words, it should not automatically follow with a "knee-jerk" regulatory response. The high profile developments attracting recent media attention do not reflect the experience of even most listed companies, let alone most executives in the top few hundred companies in Australia.

There should be cogent reasons offered as to why further regulation is required and this should only be done after a thorough cost-benefit analysis. The Commission should not overlook the present capacity and ability for shareholders to participate in corporate affairs, including voting for directors or voting on executive remuneration. Any perceived deficiency in executive remuneration, may not necessarily result in the law being

[1] Examples of recent cases, where executives and non-executive directors have exercised freezing or restraints, include Wesfarmers, Westpac, Rio Tinto, ANZ, Qantas, and AMP.
[2] http://www.smartcompany.com.au/media/rupert-murdoch-tops-list-of-highest-paid-executives-but-pay-will-fall.html

inadequate per se, but may be a result of stakeholder' information deficiency or under-utilisation of the current laws.

Whilst we appreciate that the Commission's terms of reference is focused on executive remuneration, it must also be recalled that there are other professionals, for example, in our sports, entertainment, business, medical and legal industry, that are remunerated above and beyond most average Australian incomes and corporate executives. These professions are not subject to detailed regulatory interventions or restrictions in terms of total remuneration packages or termination payments. Such persons would earn many times over that of an average Chief Executive or senior executive in most Australian firms, and without any clear measurable benchmark to overall performance or result.

Outrage by the community following media announcements of an executive's "headline" or "all-in" termination payouts obscures the fact that a termination payment is made up of many components (mostly to comply with contractual and statutory requirements).

Whilst the Commission should consider international best practice in its consideration of the issues, it is important that this be considered in the context of Australia's current regulatory environment and domestic circumstances.

The Commission should consider whether regulatory intervention (and the extent thereof) will produce benefits which outweigh costs, including any unintended consequences. Consequences include how regulatory measures may affect the performance of the company in the short to long term and how this may ultimately affect shareholders, consumers, employees and the community as a whole. A regulatory response that applies to all firms, and which seeks to address a handful of recent cases, may ultimately be counter-productive in the long term.

Whilst not supportive of a regulatory response, if imposed it must be workable in the short to long term and should undergo a mandatory review.

As a general principle, all regulatory measures should be operate prospectively and should provide an adequate period of time for implementation and transition.

Regulatory responses that include the imposition of criminal and/or civil sanctions should be carefully considered as this will impact upon the company's own stakeholders.

2. Listed Companies vs Unlisted: The focus of the inquiry and any recommendations should be on *listed* companies and existing regulatory structures. It should primarily focus on the role of the board, shareholders and their executives.

It will be important that the Commission considers all unintended consequences to non-listed companies (which include many large, medium and small firms), and the not-for-profits. Furthermore, the Commission should be cautious that it targets its approach to those executives that are currently regulated. Definitions of "company executives" should be carefully considered before proposing any regulatory measures which may have

unintended consequences to other employees in a company who are not such positions of leadership or authority.

3. Remuneration Comparisons: Whilst the Commission should explore all issues associated with remuneration, any suggestion that comparisons between executive salaries and other employees should be a determinate of executive pay should be cautiously considered, particularly if it is linked to a regulatory measure. Whilst the raw data does not provide any evidence of itself, we would question the probative value of such research and ask how it would provide any answers as to whether existing governance mechanisms on executive remuneration are deficient.

4. Legal Issues: There must also be an appreciation of the intersection between corporate regulation and other areas of law which is inextricably linked to overall remuneration and termination issues. For example, as executives are also (in most cases) employees, employment and industrial law issues must be taken into account. In the case of remuneration and termination issues, legal obligations arising from a company's common law, equity and statutory obligations must be carefully considered (the Commission may not be aware that the *Fair Work Act 2009* will apply from 1 July 2009 to all employees, even CEOs and other highly remunerated employees, just as the *Standard* under the *Workplace Relations Act 1996* currently applies to such employees).

It is typical (as it is legally required) for long service leave, notice of termination, severance pay, unused leave and other benefits to be paid out upon departure (ie. legal on-costs). It is also not uncommon for a *deed of release* to be entered into at the time of departure, which also contains a monetary component (this may address issues such as potential legal claims, payments to compensate early termination of a fixed-term contract, vesting of options and shares etc).

As a relevant example, any proposed measure that links termination payments to the quantum of an executive's annual base salary can be dramatically affected by *notice* provisions, where it would not be unusual for a 3-6 month payment in lieu of notice (which takes into account non-base salary components, plus other components) to easily amount to the equivalent of 12 months base-salary.

It is not unusual for an executive to relocate, expend costs and leave an otherwise stable position to join a new firm. It is also not uncommon in the cases of buyouts, restructures, or mergers/acquisitions for an executive's position to be terminated before their term has expired. This is why executives are remunerated for a legitimate amount of *operational* risk. It must also be recognised that executives are also remunerated for a high degree of *legal* risk, in that Australian laws extend to personal legal liability (for civil and criminal offences, carrying terms of imprisonment) to many company officers who exercise control over a company's affairs.

Should termination payments be limited or capped, this may send a signal to the market that there is not enough adequate protection and compensation for executives in the case of early terminations. And should remuneration packages not compensate for a high

degree of legal liability that is taken on by executives; this will also send a wrong signal to attracting appropriately skilled and talented leaders. These issues should be carefully considered.

The Commission should also consider that termination payments may also involve compensation to ensure that executives are restrained for a reasonable period of time, from working with competitors (ie. restraint of trade clauses). Because of the lengthier and more excessive restrictions on an executive than other employees, the *quid pro quo* is often a higher than average premium to an executive. The Commission should be mindful that restrictions on company's ability to deal with such matters may ultimately have counter-productive results in the end.

5. Unintended Consequences: With respect to regulating termination payments, a real and not illusory unintended consequence will be a culture of "front loading" executive contracts with larger base salaries, sign on bonuses and other monetary or property interests to avoid harsh restrictions imposed on termination payments. This will distort and artificially decouple performance related incentives in the long term and should be carefully considered.

The Commission should also consider any proposal with a view that a regulatory measure could be counter-productive to (a) local firms and shareholders competing on the global stage for talented and experienced executives who not only bring experience and expertise, but also cultural insight that can make valuable contribution to the local Australian economy or (b) local leaders becoming Australian "ex-pats" to overseas firms which has an even more dramatic counter-productive effect to local firms and the community.

Whilst we reiterate that it is our view this review should predominantly consider listed entities, a perverse outcome no one would want to see, if for executives to move from listed firms to private firms or to be engaged as consultants due to the introduction of an excessive or wider regulatory measures.