

# Executive Remuneration in Australia: Perpetual's submission to the Productivity Commission on its discussion draft Report

## 1 Introduction

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Perpetual is a major member of the Australian funds management industry. As a publicly listed company and leading institutional investor in the Australian marketplace, Perpetual has over 120 years' experience in helping Australians invest and manage their wealth through all market conditions.

Today, Perpetual is one of the Top 100 companies listed on the Australian Securities Exchange, and manages investment funds exceeding \$26 billion, administers over \$241 billion of client funds, and advises clients on over \$6 billion of investments (as at 30 June 2009).

Perpetual maintains a strong interest in policy which affects both the rights of shareholders and remuneration of employees. We are pleased to provide the following submissions from the perspective of an employer and institutional investor in response to the Productivity Commission's discussion draft Report on Executive Remuneration in Australia.

Perpetual's Chief Executive Officer, David Deverall, is the current chair of the Investment and Financial Services Association Limited.

## 2 Submission outline

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Perpetual makes the submissions on all recommendations as provided in the table below.

## 3 Submissions

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### 3.1 Ending the 'no-vacancy' rule

Draft recommendation	Perpetual's comment
1 End the 'no vacancy' rule	<p>Opposed.</p> <p>While the Commission's suggestion that the 'directors club' be broken up may be one intended outcome, this recommendation may also have unintended consequences, for example, increasing the size of boards, making them unworkable, and introducing directors who disrupt board functionality for reasons that may not be in the best interests of the company and shareholders.</p> <p>An alternative suggestion is to focus on the board nominations committee to a greater extent.</p>

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### Expanded comments

The Commission commented that it is:

*'not the individual characteristics of each board member that are most important, rather it is the way in which these members work together and collectively make decisions regarding the company.'*

While removing the 'no vacancy' rule may increase the size of boards, it may also have the unintended consequence of board composition being affected to the detriment of its collective decision making ability.

Perpetual submits that a greater focus should be placed on the role of the board nominations committee to promote diversity and functionality of a board through its membership. This would include:

- utilising external recruitment consultants to undertake searches based on skills and experience required on the board to best meet the needs of the company and the shareholders;
- promoting a greater focus on the processes involved in board nominations;
- raising the standards of the committee to ensure that board accountability begins with the process of board nomination.

## 3.2 Remuneration committee independence

Draft recommendation	Perpetual's comment
<p>2 Ensure remuneration committee independence – ASX300</p>	<p>Supported.</p> <p>Independence will assist in minimising the scope for executives to influence their own remuneration structure and remove actual and perceived conflicts of interest.</p> <p>The promotion of shareholder confidence and increased transparency in the eyes of the general public can only serve to improve negative sentiment surrounding executive remuneration in the wider community and, hence, market integrity.</p> <p>The resources associated with compliance are outweighed by the benefits from the independence of remuneration decisions.</p>
<p>3 Promote remuneration committee independence – 'comply or explain'</p>	<p>Supported.</p> <p>If the ASX Corporate Governance Council does not agree then the requirement could be contained in legislation.</p> <p>Should recommendation 3 not be adopted, Perpetual does not support an extension of recommendation 2 to all listed companies. Lower revenue-generating companies are already at a disadvantage in being able to attract higher skilled executives and placing remuneration committee requirements upon such companies could further disadvantage them.</p>

### Expanded comments

Perpetual views the requirement for an independent structure of remuneration committees for ASX300 companies, with the requirement for a 'comply or explain' recommendation, as necessary to ensure an appropriate level of investor confidence on this issue.

It is agreed that the requirement for independence for remuneration committees will assist in minimising the scope for executives to influence their own remuneration structure. Independence would remove any actual or perceived conflict of interest where executives have the ability to make or influence decisions regarding their own pay. This would assist not only in promoting shareholder confidence, but also improve the general public's views on executive remuneration, which have been given increased credence given bad examples of pay for underperformance and hence, lack of integrity in financial markets.

While there may be compliance and time costs associated with these recommendations, it is submitted that the resulting benefits in shareholder perception will provide long term benefits for individual companies and the market in general.

Perpetual also agrees that the ASX Corporate Governance Guidelines should be elevated beyond a 'suggested' committee structure. Should the ASX Corporate Governance Council oppose this position, one option may be to enshrine such a change into the corporations legislation.

In response to the specific question asked in the draft Report, Perpetual considers that given the Commission's comments to the effect that executive pay levels are of concern only in larger companies, and the perceived additional burden to organisations of paying and facilitating independent remuneration committees, that it would be disproportionately onerous to extend the remuneration committee requirements beyond ASX300 companies in the event that draft recommendation 3 were not adopted.

### 3.3 Voting on remuneration

Draft recommendation	Perpetual's comment
4 Prohibit executives and directors voting on remuneration	Supported in relation to executives, opposed in relation to directors.
5 Prohibit executives hedging	Supported.
6 Prohibit executives and directors voting undirected proxies on remuneration matters	Supported in relation to executives, opposed in relation to directors.
7 Oblige all directed proxies to be cast on remuneration reports and any other remuneration-related decisions	Supported regarding remuneration-related resolutions. In addition, Perpetual suggests that a requirement is introduced so that shareholders are provided with clearer information and voting forms in order to provide their direction.

### Expanded comments

In relation to recommendations 4 and 6, Perpetual supports moves to prevent *executives* from voting and/or voting undirected proxies on remuneration matters that relate to the executive's remuneration. However, Perpetual opposes any limit on *directors* voting in this capacity, as directors often represent the interests of shareholders in companies and not merely their personal interests. To take this capacity away from directors may amount to taking this capacity from shareholders, in contrast with the intention of many of the Commission's other recommendations.

Perpetual supports the Commission's position on hedging in recommendation 5 and notes that many companies already require that executives be prohibited from hedging equity.

On obliging that all proxy holders be required to cast all of their directed proxies on remuneration reports and any other remuneration-related decisions, Perpetual supports this position in relation to remuneration-related decisions only. Further, Perpetual encourages regulation to clarify proxy allocation and information forms for shareholders providing proxies.

It is also submitted that, at present, directors play a role in voting in the interests of the company on behalf of shareholders, and that a move to direct that proxy holders vote on particular issues, while in theory providing for greater shareholder 'interest' in remuneration matters, could diminish the role of boards as a function for generating the most 'desirable' outcome for a company as shareholder representatives. Further, shareholders may direct proxies due to their trust and faith in the board, or particular directors. By eliminating this option, sub-optimal decisions may result due to 'involuntary' decision making.

## 3.4 Content and disclosure of remuneration reports

Draft recommendation	Perpetual's comment
<p><b>8</b> Improve information content and accessibility of remuneration reports</p>	<p>Supported.</p> <p>Clearer content will assist shareholders and other market participants to assess marketable securities by considering company remuneration policies.</p> <p>Perpetual proposes:</p> <ul style="list-style-type: none"> <li>• the use of a central body or 'standards board' to monitor the content of remuneration reports; and</li> <li>• content is not prescribed but fluid and evolving based on market expectations and requirements.</li> </ul> <p>At present, there is a risk that 'over disclosure' reduces the transparency of remuneration information provided.</p> <p>Perpetual has provided suggestions for improving the 'relevance and readability' of remuneration reports.</p>
<p><b>9</b> Remove superfluous disclosure – KMP only</p>	<p>Supported.</p> <p>Perpetual is supportive of measures which reduce the resources associated with producing a remuneration report without diminishing investors' opportunity to make an informed assessment of remuneration policies.</p>

Draft recommendation	Perpetual's comment
Finding 1: Remuneration 'check list' for boards	<p>Supported so long as all items on checklist not compulsory.</p> <p>Perpetual supports the continual evolution of remuneration reports and the use of a central body to check compliance and content of remuneration reports on an ongoing basis.</p>

### Expanded comments

Shareholders, and the market in general, need to be in a position to assess company remuneration practices and policy. At present, many shareholders struggle to understand the information available, despite disclosure under the current remuneration report requirements in the corporations legislation. Perpetual is supportive of recommendations which make remuneration reports 'easier to read' and confine remuneration reports to key management personnel.

Perpetual agrees with the Commission's view that remuneration reports are often long and complex and incomprehensible to lay and even expert readers. It is submitted that simplifying the content and disclosure of remuneration reports into a plain English summary statement of companies' remuneration policies will assist in reducing the risk of 'over disclosure' clouding transparency of remuneration information provided. Not only will this encourage greater understanding by retail investors, but it will also assist them in making a judgement on whether remuneration is in line with both a companies' published remuneration policies as well as purported performance strategies.

The concept of remuneration reports and disclosure is continually evolving, and Perpetual recommends the use of a central body or 'standards board' to monitor the evolution of remuneration reports. The intention is not to create a bureaucratic body, but rather one which could serve to provide best practice guidelines on remuneration reporting within Australia.

While it is submitted that an all-inclusive 'prescriptive list' should not be compulsory due to the ever-changing nature of remuneration reports and the necessarily different requirements of shareholders based on a company's size and industry, Perpetual provides the following specific suggestions for improving the 'relevance and readability' of remuneration reports:

- Providing an informative and 'easy to compare' summary of executive pay (including 'actual' values);
- Summarising key points and themes in the report;
- Providing a 'language dictionary' so that readers can easily reference and understand terms contained within the report;
- Providing an overview of the use of internal and external executive remuneration processes;
- Summarising key policies and overall approach to executive remuneration;
- Outlining relevant company policies in relation to the trading of securities;
- Summarising executive pay matched against measurable targets (where applicable); and
- Summarising key contract terms affecting executive remuneration for KMPs, including contract term and time basis for relevant incentives.

Though larger organisations may be able to absorb the resources required to comply with remuneration disclosure requirements, Perpetual is supportive of any measure which reduces the resources associated with producing a remuneration report without diminishing an investor's opportunity to make an informed assessment of remuneration policies.

Perpetual makes a further caveat regarding enhanced disclosure – commercially sensitive information which, if disclosed, may provide competitors or the market with an insight which could jeopardise performance or competitiveness, should not be required to be disclosed.

### 3.5 Remuneration advisers

Draft recommendation	Perpetual's comment
10 Require remuneration advisers to be independent of management – ASX300	Supported – but only where remuneration advisers are utilised for the purposes of KMP remuneration.
11 Require remuneration advisers and the nature of their work to be disclosed –	Supported.

#### Expanded comments

Perpetual submits that while it is appropriate for remuneration advisers to be independent of management for the purposes of advising in relation to KMP remuneration, it would be practically unworkable to extend the requirement for independence beyond KMP. For example, taking the 'independent approach' as far as middle-tier employees who are not KMP would be an unnecessary waste of board time and company resources.

### 3.6 Voting of institutional investors

Draft recommendation	Perpetual's comment
12 Institutional investors to disclose their voting on remuneration reports	Supported. This is consistent with IFSA guideline 3.

#### Expanded comments

Perpetual is supportive of this recommendation and submits that the recommendation is consistent with, and extends further, the Investment and Financial Services Association Limited (**IFSA**) Blue Book Guidance Note No. 2.00 on Corporate Governance (**Blue Book**) Guideline 3 which states that:

'Fund managers should vote on all Australian company resolutions where they have the voting authority and responsibility to do so. An aggregate summary of a Fund Manager's Australian proxy record must be published at least annually and within 2 months of the end of the financial year.'

### 3.7 Removal of cessation of employment trigger for taxation for equity-based payments

Draft recommendation	Perpetual's comment
<p><b>13</b> Remove taxing point impediment to deferred equity</p>	<p>Supported.</p> <p>The Commission's recommendation on the taxing of incentive-based pay would assist companies to ensure that KMP maintain a longer-term approach to company performance by aligning company and executive interests. Additionally, it would aid Australia's global competitiveness in the market for executive talent.</p> <p>The current tax legislation has the potential to cause a constant increase in base salary or one-off payments as 'compensation' for additional tax burdens, especially on termination of employment.</p> <p>However, Perpetual considers further complexity around executive termination payments will materially alter the executive employment market, adding complexity and further disincentive for executives in Australia and the use of appropriate remuneration components.</p>

#### Expanded comments

Perpetual is of the view that executives should be taxed when they realise the value in equity forming part of their remuneration package (or former remuneration package as the case may be). The company agrees with the Commission's view that deferral of tax on equity should be allowed past the cessation of employment.

The proposed tax legislation put forward by the Federal Government continues onerous tax implications which do not encourage a longer-term goal for executive incentives and could potentially result in increased base pay or one-off payments to executives to compensate for additional tax burdens and a move away from equity forming part of remuneration.

Perpetual is also of the view that a focus on shorter-term incentives can promote increased risk taking for more immediate benefits, which can jeopardise longer-term company performance.

It is submitted that a more appropriate approach is as suggested by the Commission and APRA, which would encourage KMPs to hold equity for a longer period of time, thus maintaining an interest in an organisation's longer term performance.

The Commission's recommendations on the tax issue would also assist Australia in remaining competitive in the global market for talent. In a country of Australia's size, small and specialised industries would be at a disadvantage should the tax laws be implemented.

Further comment was made by the Commission that using the tax system to penalise or limit executive termination payments and bonuses would not only add further complexity to executive remuneration, but also incentivise executives and their employers to structure remuneration packages in a manner which avoids taxation. Perpetual agrees with this view.

### 3.8 Electronic voting

Draft recommendation	Perpetual's comment
14 Confirm allowance of electronic voting	Supported.

#### Expanded comments

Perpetual supports this position, and notes that it is consistent with that proposed by IFSA in its Blue Book at Guideline 15 where IFSA states that:

*'it supports the development of new electronic voting systems and better communication between companies and shareholders to provide efficiencies in the proxy voting process.'*

### 3.9 Two-strikes' 25 per cent board re-election

Draft recommendation	Perpetual's comment
<p>15 25% 'no' vote on remuneration report triggers formal explanation and response</p> <p>Substantial 'no' vote on two consecutive remuneration reports triggers board election</p>	<p>Opposed.</p> <p>The percentage requirement for the 'no' vote should be lifted to at least 50%.</p> <p>Perpetual suggests that shareholders voting against the remuneration report should be required to specify the item or items in the remuneration report which are the reason for voting against the report. This will provide the board or the remuneration committee with feedback on issues to be addressed and prevent either general protest votes or protest votes stemming from non remuneration issues.</p> <p>Any election should be held at the next AGM to minimise disruption and cost.</p>

#### Expanded comment

In principle, Perpetual supports the strengthening of shareholder powers on remuneration issues. However, Perpetual is of the view that the requisite vote under the 'two-strikes' policy should be a threshold of at least 50 per cent of shareholders voting on a company's remuneration report, not 25 per cent as proposed by the Commission.

A minority vote on a pay issue is an extreme measure which could allow minority groups of shareholders to terminate board appointments including for non-remuneration based reasons. Not only does this undermine the board and its governing role, but it could also sideline the interests and views of the majority of investors.

In the short term, the position put forward by the Commission could affect a board's capacity to make decisions with any conviction or sense of direction due to the board being uncertain of its future. In the long term, a company's reputation could be put at stake and investors could lose confidence due to management being de-stabilised by minority interests.



This could have wide spread ramifications not only for company performance and market integrity, but also the ability of Australian companies to seek out the 'best and brightest' due to the instability and uncertainty that board positions would carry with them. There is also the potential for a director's reputation to be tarnished as a result of being voted off a board on the basis of consecutive 'no votes'.

Perpetual is concerned about the further risk that shareholders could use the 'no vote' as a protest against a board in relation to other company matters (for example, dividend levels), and under the present proposals there is nothing to safeguard against this. In some cases, groups of shareholders are known to traditionally vote against board policy and resolutions, and the effect of a binding 'two strike' policy could have wider ramifications for decision making within the company as directors could seek to appease shareholders in order to ensure a positive vote on remuneration. This could place in jeopardy the board's role to provide direction for the company and in the best interest of the company (not individual shareholders).

Perpetual proposes that in order to protect against potential protest votes that in reality are not motivated by remuneration issues, shareholders voting against the remuneration report should be required to specify the item or items in the remuneration report which are the reason for voting against the report. This will also provide the board or the remuneration committee with feedback on issues to be addressed.

Perpetual also considers that, in order to minimise resource use and board disruption, any director elections following two 'no' votes on a remuneration report should be conducted at the next annual general meeting.

## 4 Further discussion

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Perpetual maintains a strong interest in executive remuneration and invites further direct discussion with the Commission, in particular, regarding recommendation 15.