



**Australian Government**

**Corporations and Markets  
Advisory Committee**

# **EXECUTIVE REMUNERATION**

## **Information paper**

**July  
2010**



Corporations and Markets **Advisory Committee**

# Executive remuneration

Information paper

**July 2010**

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# 1 Introduction

*This chapter outlines the reference to CAMAC on executive remuneration and invites submissions from interested parties.*

## 1.1 Reference to the Committee

By letter received on 12 May 2010 (a copy of which is Appendix 1), the Minister for Financial Services, Superannuation and Corporate Law, the Hon. Chris Bowen MP, referred a number of aspects of Australia's executive remuneration framework to CAMAC for its consideration and advice.

By way of background, the Minister observed that:

the Productivity Commission (PC) recently released a report examining the director and executive remuneration framework in Australia [*Executive Remuneration in Australia* (December 2009)]. The Government commissioned the inquiry in March 2009, as part of its broader response to community concerns about inappropriate remuneration practices.

The PC's broad ranging terms of reference enabled it to undertake an extensive review spanning all aspects of Australia's remuneration framework applying to listed companies. The report concluded that Australia's corporate governance and remuneration frameworks are ranked highly internationally. However, the report makes a number of recommendations that are designed to further strengthen Australia's remuneration framework.

The PC recommended that the Australian Government establish an expert panel under the auspices of the Australian Securities and Investments Commission (ASIC) to advise on how best to revise the legislation in regard to remuneration reports. In the Government's response to the PC report, released on 16 April 2010, it supported this recommendation but noted that, in CAMAC, the Government already had access to a suitably experienced advisory panel capable of providing advice on the relevant legislation.

The Minister referred the following matters to CAMAC.

### 1.1.1 Remuneration reporting

In his letter, the Minister referred to the annual remuneration report that companies are required to prepare under s 300A of the Corporations Act. In that context, he observed that:

The PC's report concluded that the usefulness of remuneration reports has been diminished by their complexity, placing a significant burden on companies and leading investors to find it impenetrable and sometimes misleading. Additionally, some information of use to shareholders—for example, pay as actually realised by executives—is not required to be reported.

The Minister has requested CAMAC to:

- **examine the existing reporting requirements contained in section 300A of the Corporations Act and related regulations and identify areas where the legislation could be revised in order to reduce its complexity and more effectively meet the needs of shareholders and companies**

- **make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports.**

### 1.1.2 Remuneration arrangements

In his letter, the Minister referred to the significance of the incentive components of executive remuneration arrangements for companies and their shareholders:

A separate but related issue is the importance of aligning executive remuneration with company performance and the usefulness of ‘at risk’ remuneration in achieving this aim. Highly complex remuneration schemes can obscure this nexus between performance and pay. The Government would therefore also like CAMAC to provide recommendations on how the incentive components of executive pay arrangements could be simplified in order to improve transparency and strengthen the correlation between the interests of a company’s executives and the interests of its shareholders.

Also, the Government, in its response to the PC report, stated that:

The recent global financial crisis highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed. The crisis has also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia’s corporate directors and executives.<sup>1</sup>

The Minister has requested CAMAC to:

- **examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements**
- **make recommendations on how best to revise the legislative architecture to simplify the incentive components of executive remuneration arrangements.**

The Minister has requested CAMAC to report on these matters by 30 November 2010.

## 1.2 Overview of the paper

To facilitate submissions from interested parties on the matters referred to CAMAC, or any related matter, this paper sets out, for information only and without seeking to compare or evaluate, some of the approaches taken in Australia and elsewhere, by regulatory and other means, to:

- the structure and content of executive remuneration arrangements, including the use and implications of the various types of incentives
- reporting on executive remuneration arrangements.

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<sup>1</sup> *Australian Government Response To the Productivity Commission’s Inquiry on Executive Remuneration in Australia* (April 2010), p 1.



### 1.2.1 Remuneration arrangements

#### *Australia*

Except for limited controls on remuneration arrangements, such as restrictions on termination benefits<sup>2</sup> and foreshadowed controls on hedging,<sup>3</sup> the legislative focus is on the disclosure of a company's remuneration arrangements, not their content.

An outline of aspects of the Productivity Commission report dealing with remuneration arrangements is set out in Section 3.1.

The Australian Securities Exchange (ASX) Corporate Governance Council *Principles and Recommendations*, which apply to all listed entities, provide guidance on remuneration packages for executive and non-executive directors (see chapter 4).

The Australian Prudential Regulatory Authority (APRA) requires financial institutions to establish a board remuneration committee and develop a remuneration policy, and gives guidance on these matters (see chapter 5).

Various private sector professional and industry bodies have published guidelines for remuneration arrangements within listed entities, including their observations on various incentive structures and practices (see chapter 6).

#### *United Kingdom*

*The UK Corporate Governance Code* provides guidance for designing remuneration arrangements for directors of UK listed companies (see Section 7.3). Likewise the *FSA Remuneration Code* contains observations, suggestions and directions concerning suitable remuneration policies and practices for banking and related financial institutions (see Section 7.5). There is also private sector guidance in the UK on what are seen as appropriate policies and practices for executive remuneration (see Section 7.6).

#### *European Union*

The European Commission has published recommendations dealing with remuneration policies and arrangements for EU listed companies and financial institutions (see Section 8.1).

The Committee of European Banking Supervisors has published *High-level Principles for Remuneration Policies*, addressed both to regulators and to regulated EU banking institutions (see Section 8.2).

The European Parliament, in addition to adopting a non-legislative resolution dealing with the remuneration of directors of listed companies and remuneration policies in the financial services sector, has also introduced mandatory restrictions on bonuses paid by European banks (see Section 8.3).

#### *USA*

Recent legislative initiatives are intended to introduce various changes to executive remuneration arrangements for regulated companies, including a power for a regulator to prohibit compensation arrangements for larger corporations that are seen as excessive or could lead to financial loss by the financial institution (see Section 9.2.2).

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<sup>2</sup> Part 2D.2 Division 2 (ss 200-200J).

<sup>3</sup> Section 2.7.

Also, the Office of the Comptroller of the Currency has issued *Guidance on Sound Incentive Compensation Policies* to assist US regulated banking organizations to design and implement suitable incentive compensation arrangements (see Section 9.2.3).

### ***Other international initiatives***

The Organisation of Economic Co-operation and Development (OECD), in its report *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009), and its follow-up report *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles* (February 2010) included guidance to boards on designing a suitable executive remuneration structure (see Section 10.1).

The Financial Stability Board, established by the G20, has issued *Principles for Sound Compensation Practices* (April 2009), followed up by *Implementation Standards* (September 2009), designed to provide specific guidance on remuneration governance, and the structure of remuneration arrangements, in financial institutions (see Section 10.2).

The Basel Committee on Banking Supervision has released a consultative document *Principles for enhancing corporate governance* (March 2010), containing some general principles for suitable remuneration practices within banks (see Section 10.3).

Guidance on the structure of remuneration arrangements for directors has also been provided by a number of private sector international bodies (see Section 10.4).

## **1.2.2 Remuneration reporting**

### ***Australia***

The current remuneration reporting obligations are set out in Chapter 2. An outline of those aspects of the Productivity Commission report dealing with remuneration reporting is set out in Section 3.2. Some proposals to amend the statutory requirements are set out in Section 3.2.6 and Section 6.1.2.

### ***United Kingdom***

The reporting obligations of UK listed companies under the *UK Companies Act 2006* are set out in Section 7.2. Additional executive remuneration reporting obligations applicable to UK banking institutions are summarised in Section 7.4.

### ***North America***

The executive remuneration reporting requirements for Canadian public companies are set out in Section 9.1.

The obligations of US public companies to disclose their executive remuneration arrangements are set out in Section 9.2.1. Recent legislative initiatives are intended to introduce various additional disclosure requirements (see Section 9.2.2).

## **1.3 Request for submissions**

CAMAC invites submissions on any aspect of the matters referred to the Committee (marked in bold in Sections 1.1.1 and 1.1.2) and any related matters.

CAMAC has access to the submissions to the Productivity Commission inquiry. However, CAMAC requests persons who have views on the matters that have been referred to

CAMAC to forward submissions, even if they include, or comprise, material previously submitted to the Productivity Commission.

Please email your submission, in Word format, to: [john.kluver@camac.gov.au](mailto:john.kluver@camac.gov.au)

If you have any queries, you can call (02) 9911 2950.

Please forward your submissions by **Friday 13 August 2010**.

All submissions, unless marked confidential, will be published at [www.camac.gov.au](http://www.camac.gov.au)

Given the time constraints, this paper is published in electronic form only.

#### 1.4 Advisory Committee

The Advisory Committee is constituted under the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, to provide advice to the Minister about corporations and financial services law and practice.

The members of the Advisory Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of the Advisory Committee are:

- Joanne Rees (Convenor)—Chief Executive Officer, Ally Group, Sydney
- Zelinda Bafile—Lawyer, Director and former General Counsel and Company Secretary, Home Building Society Ltd, Perth
- Ian Eddie—Professor of Accounting, School of Commerce and Management, Southern Cross University, Tweed Heads
- Belinda Gibson—Deputy Chairman, Australian Securities and Investments Commission
- Alice McCleary—Company Director, Adelaide
- Marian Micalizzi—Chartered Accountant, Brisbane
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra
- Ian Ramsay—Professor of Law, University of Melbourne
- Robert Seidler—Consultant, Blake Dawson, Sydney
- Greg Vickery AM—Special Counsel, Norton Rose Australia, Brisbane.

The Executive comprises:

- John Kluver—Executive Director

- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

## 2 Legislative disclosure framework

*This chapter outlines the remuneration disclosure obligations under s 300A of the Corporations Act and related requirements.*

### 2.1 Legislative development

Significant stages of regulatory development in relation to executive remuneration are:

- before 1998, listed companies were required to disclose the number of executive officers whose pay fell within each \$10,000 band of income over \$100,000, but executives did not have to be individually identified
- in 1998, s 300A was introduced in lieu of the previous disclosure requirements. That provision required that the directors' report for a financial year include:
  - discussion of broad policy for determining the nature and amount of emoluments of board members and senior executives
  - discussion of the relationship between that policy and the company's performance
  - details of the nature and amount of each element of the emolument of each director and the five highest-paid company officers<sup>4</sup>
- since 2004, the disclosure requirements have extended to persons within the same corporate group and the specific disclosures have been included in the regulations, rather than the Corporations Act.<sup>5</sup> There has also been a requirement for a separate remuneration report to be incorporated into the company's annual report. The chair at a listed company's annual general meeting 'must allow a reasonable opportunity for the members as a whole to ask questions about, or make comments on', this report,<sup>6</sup> which is subject to a non-binding shareholder vote<sup>7</sup>
- in 2007, the substance of the main accounting standard was brought into the statute and the regulations and the scope of the statute was made to correspond with the scope of the accounting standard, including by applying the disclosure requirements to 'key management personnel' of a company<sup>8</sup>

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<sup>4</sup> These amendments to the Corporations Act were introduced by the *Company Law Review Act 1998*.

<sup>5</sup> These amendments to the Corporations Act were introduced by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*.

In relation to corporate groups, the Explanatory Memorandum states (at para 5.420):

The intent of these provisions is to provide a better picture of remuneration practices across the corporate group and to prevent corporate structures being used as a way of circumventing the reporting requirements.

<sup>6</sup> s 250SA.

<sup>7</sup> s 250R.

<sup>8</sup> These amendments to the Corporations Act were introduced by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007*. The meaning of 'key management personnel' is set out in Section 2.5 of this paper.

- in 2009, termination benefits for company directors and senior executives of disclosing entities exceeding one year's average base salary were made subject to shareholder approval.<sup>9</sup>

## 2.2 Overview of the current framework

Directors are obliged to include, in a separate and clearly identified section of the annual report, specific information on executive remuneration, as set out in s 300A of the Corporations Act and Corp Reg 2M.3.03 (set out in full in Appendices 2 and 3 of this paper), supported by relevant accounting standards.<sup>10</sup> The current framework is discussed in detail in Sections 2.3 to 2.6 of this paper.

Also, members with at least 5% of the votes that may be cast at a general meeting, or 100 members who are entitled to vote, can require the company, at any time, to disclose the remuneration paid to each director.<sup>11</sup>

In addition, the continuous disclosure requirements of the ASX Listing Rules are administered so that, if a listed company announces the appointment of a chief executive officer, the company must disclose the key terms and conditions of the relevant remuneration agreement.<sup>12</sup>

## 2.3 Concept of remuneration

'Remuneration' is defined in the Corporations Act by reference to the accounting standards.<sup>13</sup> AASB 124 defines 'remuneration' to mean 'compensation', which includes:

- (a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and

<sup>9</sup> Part 2D.2 Division 2 (ss 200-200J), introduced by the *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009*.

<sup>10</sup> Section 300A provides for the use of the accounting standards in valuing options (s 300A(1)(e)(ii)) and determining the meaning of 'key management personnel' (s 300A(1AAA)). Also, s 9 defines 'remuneration' by reference to the accounting standards.

Corp Reg 2M.3.03(4) provides that 'a company must apply the requirements of relevant accounting standards when disclosing' the prescribed details. Corp Reg 2M.3.03(5) provides that an expression 'used in the [prescribed details] and defined in a relevant accounting standard that is applied for the purpose of disclosing information has the meaning given by that accounting standard'.

The main relevant accounting standard is AASB 124 *Related Party Disclosures* (December 2009). AASB 124 applies to each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and is a reporting entity: AASB 124 at Aus1.2. Reporting entity is defined in Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity*. AASB 124.9 contains the definitions of 'key management personnel' and (in combination with Aus9.1 in the same accounting standard) 'remuneration' that are to be used in interpreting s 300A. The parts of AASB 124 that overlap with s 300A and Corp Reg 2M.3.03 (paragraphs Aus29.2 to Aus29.6, Aus29.7.1 and Aus29.7.2) do not apply to disclosing entities that are companies: Aus1.4.1.

Other relevant standards are AASB 2 *Share-based Payment* and AASB 119 *Employee Benefits*. The latter two standards, in addition to providing some key definitions, are relevant to the quantification of remuneration components.

Appendix A of AASB 2 contains the following definitions applicable to interpretation of Corp Reg 2M.3.03: 'cash-settled share-based payment transaction', 'equity instrument', 'equity-settled share-based payment transaction', 'fair value', 'grant date' and 'vest'.

AASB 119.7 contains the following definitions applicable to interpretation of Corp Reg 2M.3.03: 'employee benefits', 'post-employment benefits', 'short-term employee benefits' and 'termination benefits'.

<sup>11</sup> s 202B.

<sup>12</sup> HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [10.236].

<sup>13</sup> Definition of 'remuneration' in s 9.

non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

- (b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;
- (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;
- (d) termination benefits; and
- (e) share-based payment.<sup>14</sup>

## 2.4 Entities required to disclose remuneration

The remuneration disclosure requirements in s 300A apply to any ‘disclosing entity’ that is a company.<sup>15</sup>

The requirements also provide specifically for consolidated entities.<sup>16</sup>

## 2.5 Persons whose remuneration must be disclosed

The categories of persons covered by various parts of s 300A are:

- **key management personnel**, defined as ‘persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity’<sup>17</sup>
- **company executives**, defined as a secretary or senior manager,<sup>18</sup> with senior manager being defined as a person (other than a director or secretary of the corporation) who:
  - makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
  - has the capacity to affect significantly the corporation’s financial standing<sup>19</sup>
- **group executives**, defined in relation to a consolidated entity as the directors and secretaries of companies or bodies within the entity and the senior managers of any corporation within the consolidated entity.<sup>20</sup>

The discussion in Section 2.6 highlights in bold italics which of these persons are covered by specific requirements.

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<sup>14</sup> AASB 124.9.

<sup>15</sup> s 300A(2). ‘Disclosing entity’ is defined in s 9, which cross-refers to s 111AC.

<sup>16</sup> s 300A(1)(a)(ii), (ba), (c)(i) & (iii), (1B)(b), (4).

<sup>17</sup> AASB 124 *Related Party Disclosures* (December 2009, applicable by virtue of s 300A(1AAA)) at Aus 124.9.

<sup>18</sup> s 300A(1B)(a).

<sup>19</sup> Paragraph (a) of the definition of ‘senior manager’ in s 9 (the other paragraphs relate to partnerships, trusts and joint ventures).

<sup>20</sup> Paragraphs (a), (b) and (c) of the definition of ‘group executives’ in s 9 (the other paragraphs relate to partnerships, trusts and joint ventures).

## 2.6 Details to be disclosed

### 2.6.1 Overview

The details of remuneration, to be included in the directors' report in a separate section headed 'Remuneration report',<sup>21</sup> relate to:

- board policy on remuneration and its link to corporate performance (see further Section 2.6.2)
- general matters, such as a person's name, position in the company and time in office (see further Section 2.6.3 under the heading *General*)
- the composition of a person's remuneration package, including short-term, long-term, post-employment and termination benefits and bonuses and share-based payments (see further Section 2.6.3)
- performance conditions (see further Section 2.6.4)
- additional information where securities are an element of the remuneration (see further Section 2.6.5)
- additional information where options are an element of the remuneration (see further Section 2.6.6)
- additional information where a person is employed under a contract (see further Section 2.6.7).

The legislation also provides for disclosure of such other matters related to board policy as are prescribed by the regulations.<sup>22</sup> However, no such matters have been prescribed.

### 2.6.2 Board policy and its link to corporate performance

The remuneration report must include discussion of:

- board policy for determining the nature and amount (or value) of remuneration of *key management personnel*<sup>23</sup>
- the relationship between that policy and the company's performance, including:
  - the company's earnings
  - the consequences of the company's performance on shareholder wealth, having regard to dividends, changes in share price between the beginning and the end of the year, any return of capital involving a cancellation of shares at a payment above market price and any other relevant matter

in the current financial year and in the previous 4 financial years.<sup>24</sup>

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<sup>21</sup> s 300A(1), (1A).

<sup>22</sup> s 300A(1)(f).

<sup>23</sup> s 300A(1)(a)(i).

<sup>24</sup> s 300A(1)(b), (1AA), (1AB).



Observations by the Productivity Commission on this topic are set out at Section 3.2.3.

### 2.6.3 Composition of remuneration package

The remuneration report must disclose for the *key management personnel* and the five *company executives* or *group executives* who receive the highest remuneration:<sup>25</sup>

#### *General*

- the person's name<sup>26</sup> and position in the company<sup>27</sup> and the time the position was held (if less than the whole financial year)<sup>28</sup>
- details of changes or retirements during the reporting period<sup>29</sup>

#### *Payments and benefits*

- *short-term employee benefits*,<sup>30</sup> including:
  - cash salary, fees and short-term compensated absences
  - short-term cash profit sharing
  - other bonuses
  - non-monetary benefits(with comparative information for the previous year<sup>31</sup>)
- *post-employment benefits*,<sup>32</sup> including pension and superannuation benefits (with comparative information for the previous year<sup>33</sup>)
- *other long-term employee benefits*, separately identifying any amount attributable to a long-term incentive plan<sup>34</sup> (with comparative information for the previous year<sup>35</sup>)
- *termination benefits*<sup>36</sup> (with comparative information for the previous year<sup>37</sup>)
- the monetary value and date of any payments made during the financial year as consideration for a person to accept a position in the company<sup>38</sup>
- *share-based payments*, divided into:
  - equity-settled

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<sup>25</sup> s 300A(1)(c). If a person falls into more than one of these categories, details of the person's remuneration need only be given under one category: final sentence of s 300A(1).

<sup>26</sup> Corp Regs 2M.3.03(1) Item 1.

<sup>27</sup> Corp Regs 2M.3.03(1) Item 2.

<sup>28</sup> Corp Regs 2M.3.03(1) Item 3.

<sup>29</sup> Corp Regs 2M.3.03(1) Items 4 and 5.

<sup>30</sup> Corp Regs 2M.3.03(1) Item 6.

<sup>31</sup> Corp Regs 2M.3.03(2).

<sup>32</sup> Corp Regs 2M.3.03(1) Item 7.

<sup>33</sup> Corp Regs 2M.3.03(2).

<sup>34</sup> Corp Regs 2M.3.03(1) Item 8.

<sup>35</sup> Corp Regs 2M.3.03(2).

<sup>36</sup> Corp Regs 2M.3.03(1) Item 9.

<sup>37</sup> Corp Regs 2M.3.03(2).

<sup>38</sup> Corp Regs 2M.3.03(1) Item 10.

- cash-settled
- other forms (including hybrids)

with the equity-settled further distinguishing between:

- shares and units, and
- options and rights<sup>39</sup>

(with comparative information for the previous year<sup>40</sup>)

### ***Compensation***

- details of any cash bonus, performance-related bonus or share-based payment, including:
  - the grant date and nature of the compensation
  - any service and performance criteria used to determine the amount
  - details of any alteration since the grant date
  - the percentage paid or vested in the financial year
  - the percentage forfeited in the financial year for failure to meet service and performance criteria
  - the subsequent financial years for which the compensation will be payable if the person meets the service and performance criteria for the bonus or grant
  - estimates of the maximum and minimum possible total value (other than for option grants) for subsequent financial years<sup>41</sup>
- any further explanation necessary to determine how the amount of compensation under a contract for services was determined and how the terms of the contract affect compensation in future periods<sup>42</sup>
- details of any alterations to the terms of share-based payments (including options or rights), including the market price of the underlying equity at the date of the alteration, the old and new terms of the payment and the difference between the old and new fair values of the equity<sup>43</sup>
- details of any options and rights over equity,<sup>44</sup> and equity issued on exercise of options or rights,<sup>45</sup> separately identifying each class of equity instrument.<sup>46</sup>

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<sup>39</sup> Corp Regs 2M.3.03(1) Item 11.

<sup>40</sup> Corp Regs 2M.3.03(2).

<sup>41</sup> Corp Regs 2M.3.03(1) Item 12.

<sup>42</sup> Corp Regs 2M.3.03(1) Item 13.

<sup>43</sup> Corp Regs 2M.3.03(1) Item 14.

<sup>44</sup> Corp Regs 2M.3.03(1) Item 15.

<sup>45</sup> Corp Regs 2M.3.03(1) Item 16.

<sup>46</sup> Corp Regs 2M.3.03(3).

In addition to the details required for each person under s 300A, the accounting standards require that companies disclose *key management personnel* compensation in total and for each of the following categories:

- short-term employee benefits
- post-employment benefits
- other long-term benefits
- termination benefits
- share-based payment.<sup>47</sup>

#### **2.6.4 Performance conditions and criteria**

The remuneration report must include:

- if an element of the remuneration depends on the satisfaction of a performance condition:
  - a detailed summary of the condition
  - an explanation of why the condition was chosen
  - a summary of the methods used in assessing whether the condition is satisfied and an explanation of why the methods were chosen
  - a summary of any comparative factors external to the company involved in the condition, identifying any companies or securities indices to which any of those factors relates<sup>48</sup>
- an explanation if a grant of securities as an element of remuneration is not subject to a performance condition<sup>49</sup>
- an explanation of the relative proportions of those elements of the person's remuneration that are related to performance and those elements of the person's remuneration that are not<sup>50</sup>
- any performance criteria used to determine the amount of a cash bonus, performance-related bonus or share-based payment.<sup>51</sup>

#### **2.6.5 Where securities are an element of the remuneration**

The remuneration report must include:

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<sup>47</sup> AASB 124.17.

<sup>48</sup> s 300A(1)(ba). This disclosure requirement is expressed to apply to 'key management personnel'. By contrast, the prescribed details must cover the five highest-paid company executives and group executives as well as key management personnel. These categories may overlap.

<sup>49</sup> s 300A(1)(d).

<sup>50</sup> s 300A(1)(e)(i).

<sup>51</sup> Corp Regs 2M.3.03(1) Item 12.

- details of *share-based payments* (see Section 2.6.3 above, under the heading *Payments and benefits*)
- an explanation if a grant of securities as an element of remuneration is not subject to a performance condition<sup>52</sup>
- a discussion of board policy on a person limiting his or her risk in relation to securities given as remuneration and the mechanism to enforce the policy.<sup>53</sup>

### 2.6.6 Where options are an element of remuneration

The remuneration report must disclose:

- options and rights as a subcategory of *share-based payments* (see Section 2.6.3 above, under the heading *Payments and benefits*)
- the value of options given as part of remuneration during the year, worked out:
  - at the time of grant<sup>54</sup>
  - where the options have been exercised—at the time of exercise<sup>55</sup>
  - where the options have lapsed because a condition was not satisfied—at the time of lapse (but assuming that the condition was satisfied)<sup>56</sup>
- the percentage of the value of remuneration for the financial year that consists of options.<sup>57</sup>

### 2.6.7 Where a person is employed under a contract

If the person is employed under a contract, the remuneration report must disclose its duration, notice periods for termination and termination payments.<sup>58</sup>

## 2.7 Foreshadowed amendments

The Government, in its response to recommendations in the Productivity Commission report (see chapter 3), has indicated that it will introduce various changes to the disclosure requirements, namely:

- confine individual remuneration disclosure requirements to key management personnel and remove the requirement to include separate disclosures for officers of a parent entity
- include in the remuneration report:
  - a plain English summary statement of the company's remuneration policy

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<sup>52</sup> s 300A(1)(d).

<sup>53</sup> s 300A(1)(da).

<sup>54</sup> s 300A(1)(e)(ii).

<sup>55</sup> s 300A(1)(e)(iii).

<sup>56</sup> s 300A(1)(e)(iv).

<sup>57</sup> s 300A(1)(e)(vi).

<sup>58</sup> s 300A(1)(e)(vii).

- actual levels of remuneration received by the individuals named in the report
- provide for a ‘two strikes and re-election resolution process’ where at the annual general meeting there is at least a 25% ‘no’ vote on the remuneration report.<sup>59</sup>

The Government has foreshadowed some other changes, including:

- prohibit key management personnel that hold shares from voting on their own remuneration arrangements and extend the prohibition to closely related parties of these personnel<sup>60</sup>
- prohibit key management personnel from hedging unvested equity remuneration or vested equity subject to holding locks and extend the prohibition to closely related parties of these personnel.<sup>61</sup>

## 2.8 Reform proposals

Various proposals have been put forward to reform other aspects of the legislative disclosure framework: see further Section 3.2.6 and Section 6.1.2.

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<sup>59</sup> *Australian Government Response To the Productivity Commission’s Inquiry on Executive Remuneration in Australia* (April 2010), pp 6-7 (response to Recommendations 8, 9 and 15 of the PC report).

<sup>60</sup> *id* at p 5 (response to Recommendation 4 of the PC report).

<sup>61</sup> *id* at p 6 (response to Recommendation 5 of the PC report).



## 3 Productivity Commission report

*This chapter summarises relevant aspects of the Productivity Commission report dealing with remuneration arrangements and remuneration reporting requirements.*

### 3.1 Remuneration arrangements

The Productivity Commission (PC) report *Executive Remuneration in Australia* (December 2009) contained a series of observations on executive remuneration arrangements.

#### 3.1.1 Elements of remuneration arrangements

Executive remuneration arrangements can include a combination of set payments ('base pay') and incentive arrangements ('at risk' payments).

The PC noted that the incentives in executive remuneration arrangements typically comprise:

- shares or options in the company, with holding requirements. These directly link executive wealth to the share price and dividends of the company
- performance-based remuneration. This may consist of cash, options or equity awarded when performance hurdles are met in the short term (generally one year) or long term (around three years). Short-term hurdles often relate to a company's financial performance, occupational health and safety outcomes or business strategy implementation, whereas long-term hurdles usually relate to broader market metrics such as total shareholder return.<sup>62</sup>

#### 3.1.2 Changing nature of remuneration arrangements

The Commission noted that there have been fundamental changes since the late 1980s in the composition of executive remuneration in Australia.<sup>63</sup> There is now a much greater focus on the variable element of remuneration, including equity-based remuneration (shares and options in the company) and other incentive-based forms of remuneration, such as bonuses.

Also, according to the PC, all of the growth in reported chief executive officer pay for the top 300 companies in the years preceding the global financial crisis was attributable to increases in incentive pay, especially 'long-term incentives' (LTIs), which tripled between 2004 and 2007. Since 2007, LTIs have fallen by around 25% and the decline in short-term incentives (STIs) ('bonuses') has been even greater.<sup>64</sup> However:

while greater use of incentive pay has almost certainly led to higher reported pay over time, in practice, it might not have translated to improved company performance. Compliant boards, or the difficulties posed for them by very complex incentive pay arrangements, could allow executives to mould performance measures and hurdles in

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<sup>62</sup> at XXV.

<sup>63</sup> at 98.

<sup>64</sup> at XVII.

their favour, so that ‘at risk’ pay becomes a virtual certainty, perhaps even rewarding and encouraging poor performance.<sup>65</sup>

### 3.1.3 Assessment of remuneration arrangements

The PC noted that it has not been possible to ascertain conclusively whether executive pay in Australia has been appropriately set by boards. On the one hand, there are various indicators in favour, including that options (which can deliver large returns in rising markets) and hidden company loans have not been widely adopted in Australia compared to the United States, and long-term incentive hurdles (at least since the early to mid 2000s) have been increasingly linked to shareholder return relative to comparable companies, constraining excessive rewards for ‘good luck’.<sup>66</sup>

On the other hand, the Commission referred to some contrary considerations, including that incentive pay invariably is challenging to design and seems to have been introduced in the 1990s without adequate understanding by some boards, with ‘permissive’ hurdles delivering strong pay growth in that decade.<sup>67</sup>

The PC concluded that the complexity of some recent incentive pay arrangements could have allowed unanticipated upside (especially during the share market boom prior to 2007-08), yet weakened or distorted the incentive effects for executives, in that:

- short-term incentives linked to inappropriate performance measures in the finance industry in some instances encouraged excessive risk-taking, although they appear to have been far less pervasive in Australia than overseas
- some executives may view certain complicated long-term incentives linked to share market performance as akin to a lottery: they may have little (positive or negative) incentive effect, yet could end up delivering large payments to the executive at large cost to the company.<sup>68</sup>

In terms of promoting efficient incentive alignment, the PC commented that:

While there is no single ‘right’ pay structure for aligning incentives, investors might be reassured if boards have, for example, undertaken prudent risk assessments and sensitivity analysis in crafting incentive pay arrangements, as well as considered the scope for simpler and potentially less costly pay structures.<sup>69</sup>

## 3.2 Remuneration reporting

### 3.2.1 The reporting problem in practice

The PC report observed that:

A major area of concern is the length and complexity of reports, with many investors stating they find them impenetrable ... Reports are routinely 20 pages in length, and some are over 50 pages. Both their length and complexity reflect the breadth and complexity of remuneration arrangements. They also reflect what companies consider they must do to comply with the not insignificant statutory requirements. A number of

<sup>65</sup> at XXII.

<sup>66</sup> at XXIII.

<sup>67</sup> at XXIV.

<sup>68</sup> at XXV.

<sup>69</sup> at XXX-XXXI.



participants described the approach commonly taken by companies as legalistic ‘boiler-plating’—that is, they attempt to shield themselves by using standard terms to describe arrangements. Such terminology is not particularly illuminating for investors.<sup>70</sup>

The PC recognised that, in view of the problems in practice, there was a need to streamline and review the regulatory framework. However, it also recognised that there will always be some tension between report readability and length,<sup>71</sup> and the need to balance transparency and simplicity:

maximum ‘transparency’ (disclosing everything possible) may only confuse shareholders, while an emphasis on ‘simplicity’ could leave shareholders with too little access to detail. Hence, it is important to consider not just what remuneration reports should contain, but also how the content should be presented.<sup>72</sup>

### 3.2.2 Benefits and possible problems in remuneration disclosure

The PC report identified various benefits of remuneration disclosure.

- Remuneration disclosure makes boards more accountable and provides information about company prospects.<sup>73</sup>
- Remuneration disclosure is one mechanism for constraining the scope for company directors to benefit from their position by awarding themselves excessive pay, and also for providing reassurance to shareholders that they are not doing so. While executives technically do not set their own pay, disclosure of executive remuneration can make the board more accountable and reassure investors that the board is negotiating with executives at ‘arm’s length’.<sup>74</sup>
- Disclosure of remuneration packages assists investors to assess the company’s prospects and risk profile. Thus, through improving investor confidence and providing relevant information about company prospects, disclosure could enhance efficiency in equity markets.<sup>75</sup>

The PC report acknowledged certain problems that may arise with remuneration disclosure.

- The usefulness of remuneration reports is diminished by their length, detail and complexity, as well as by ‘boiler-plating’ and some crucial omissions.<sup>76</sup>
- Unlimited disclosure would be unlikely to deliver net benefits—for instance, detailed revelation of a company’s strategy could undermine its competitive advantage and long-term performance.<sup>77</sup>
- The benefits of transparency need to be balanced against compliance costs and possible adverse consequences for a company’s commercial position.<sup>78</sup>

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<sup>70</sup> at 247.

<sup>71</sup> at 241 **Key points**.

<sup>72</sup> at 248.

<sup>73</sup> at 241 **Key points**.

<sup>74</sup> at 241.

<sup>75</sup> at 242.

<sup>76</sup> at 241 **Key points**.

<sup>77</sup> at 242.

- The costs to the company associated with producing a remuneration report are substantial. These costs arise from the significant time and effort required from management to draft the remuneration report, the engagement of external consultants to assist with this specialised task, and the cost of obtaining appropriate legal and audit compliance checks.<sup>79</sup>
- Time spent by non-executive directors on compliance issues such as the remuneration report can be to the detriment of oversight of strategic and business risk issues.<sup>80</sup>

### 3.2.3 Remuneration policy and its link to corporate performance

The PC observed that ‘a company’s remuneration policy provides information on how remuneration of key management personnel is determined and the philosophy behind that approach’, as well as ‘an indication of the company’s broader approach to performance and strategy’.<sup>81</sup>

However:

Section 300A of the Corporations Act does not prescribe what should be covered in the policy, simply stating the remuneration report should include discussion of board policy for determining the nature and amount of remuneration of key management personnel.<sup>82</sup>

In practice, companies typically:

do not normally separately discuss the link between the remuneration policy and company performance. Instead, the remuneration policy will sometimes include reference to company performance, while discussion of short- and long-term incentives illustrates how remuneration is related to company performance. In addition, remuneration reports often include performance information (total shareholder returns), sometimes compared to long-term incentive arrangements.<sup>83</sup>

The PC considered that remuneration reports should identify more clearly the relationship between board policy on remuneration and board performance. For instance, one matter worthy of discussion would be:

how remuneration is structured to align with the company’s (and ultimately shareholders’) interests, taking account of the company’s growth plans, strategy and risk profile.<sup>84</sup>

This would expand on the factors currently mentioned in s 300A as being relevant to the relationship between board policy and the company’s performance.

### 3.2.4 Plain English summary

Various submissions to the PC inquiry saw scope for improving clarity in the discussion of remuneration policy and arrangements.<sup>85</sup> On one view:

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<sup>78</sup> at 242.  
<sup>79</sup> at 252.  
<sup>80</sup> at 252.  
<sup>81</sup> at 252.  
<sup>82</sup> at 252.  
<sup>83</sup> at 244.  
<sup>84</sup> at 250.

Requiring plain English explanations might provide a useful signal even if it were impractical to enforce fully in practice.<sup>86</sup>

However, some inquiry participants expressed reservations about a plain English summary.<sup>87</sup> One participant<sup>88</sup> observed:

The inclusion of a plain-English summary of remuneration policies is unlikely to address the issues of complexity and ability to be readily understood by investors. Rather, it is likely to increase the overall length of the remuneration report, add to compliance costs and lead to unnecessary further debate where investors seek to reconcile points of detail in the statutory report with the general comments in the plain-English section. In addition, what is considered plain-English is subjective and likely to differ between readers.

It was suggested to the PC inquiry that the plain English summary of policies should be non-statutory, as the comprehensibility of a ‘plain English’ document would likely be compromised by the use of legalistic language if it were prescribed by the Corporations Act.<sup>89</sup> One approach might be for representative (including investor) bodies to develop a best practice guide in this area.<sup>90</sup> In addition, or as an alternative, company reports that clearly convey information to investors could be identified and publicised as best practice.<sup>91</sup>

The PC recommended that remuneration reports should include a plain English summary statement of companies’ remuneration policies.<sup>92</sup> The Government has accepted this recommendation (see Section 2.7).

### 3.2.5 Other reporting matters

The PC recommended that remuneration reports include actual levels of remuneration received by the individuals named in the report.<sup>93</sup> The Government has accepted this recommendation (see Section 2.7).

The PC report identified various other measures for improving remuneration disclosure:

- the use of a summary flowchart ‘to promote a clearer understanding of the links between company performance and remuneration outcomes, as well as the links between an individual’s total incentive payment, individual performance and department performance, and ... overall performance’<sup>94</sup>
- a descriptive, ‘at a glance’ summary, to identify the main features of the remuneration framework<sup>95</sup>

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<sup>85</sup> ACSI (sub. DD156), Charles Macek (sub. 55), Chartered Secretaries Australia (sub. 57), CGI Glass Lewis and Guerdon Associates (sub. 80), Hay Group (sub. 84), Kym Sheehan (sub. DD137), PricewaterhouseCoopers (subs. 85 and DD138) and Ernst and Young (subs. 92 and DD136).

<sup>86</sup> PC report at 254.

<sup>87</sup> For example, Australian Shareholders’ Association, sub. DD121; Australian Securities Exchange (ASX), sub. DD142.

<sup>88</sup> KPMG (sub. DD145, p. 2), quoted in the PC report at 253.

<sup>89</sup> at 253.

<sup>90</sup> at 254.

<sup>91</sup> at 254.

<sup>92</sup> Recommendation 8.

<sup>93</sup> Recommendation 8.

<sup>94</sup> at 248.

<sup>95</sup> at 249.

- requiring a short-form report,<sup>96</sup> or a succinct overview or summary of remuneration policy and arrangements at the beginning of the report,<sup>97</sup> additional to the existing report. While a short-form report could enhance accessibility for investors,<sup>98</sup> the PC acknowledged that it:
  - could add to the significant time and effort already involved for companies and their boards to comply with their disclosure obligations<sup>99</sup>
  - may not add value if it simply replicated a subset of complex material from the full report or, at the other extreme, gave an overly simplistic and potentially misleading view of complex remuneration structures.<sup>100</sup>

The Commission considered that aspects of remuneration worthy of discussion in the remuneration report should include:

- *[Alignment with company interests]* how remuneration is structured to align with the company's (and ultimately shareholders') interests, taking account of the company's growth plans, strategy and risk profile
- *[Respective roles of fixed pay and short- and long-term incentives]* what roles fixed pay, and short- and long-term incentives play in the company's remuneration policy
- *[Benchmarking against peers]* whether the company has sought to benchmark remuneration levels and structure against relevant peers
- *[Sensitivity analysis on potential outcomes]* to what extent sensitivity analysis has been undertaken to project potential remuneration outcomes, particularly in the light of extreme share price movements and in performance against selected metrics
- *[Modification of formula-based obligations to guard against 'excessive' pay]* given the possibility of extreme share price movements or other unexpected performance outcomes, to what degree formula-based contractual obligations can be modified to guard against 'excessive' pay
- *[Reason for choosing particular instruments]* why specific remuneration instruments have been selected, and whether simpler alternatives were considered
- *[Contractual provisions on termination]* what contractual provisions apply in the case of termination, particularly with regard to poor performance
- *[Evaluation of policies over time]* how remuneration policies and practices are evaluated over time, taking account of pay outcomes, the relationship between pay and performance, and the results of sensitivity analysis.

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<sup>96</sup> at 251.

<sup>97</sup> at 252.

<sup>98</sup> at 251.

<sup>99</sup> at 251.

<sup>100</sup> at 251.

### 3.2.6 Proposals by respondents to reform the reporting requirements

A number of respondents to the PC inquiry put forward proposals on reforming the remuneration reporting requirements. The section of the PC report that summarises these proposals is set out below.<sup>101</sup>

#### Remuneration report design

Ernst and Young (sub. DD136) provided the framework for what they considered an ‘ideal’ remuneration report. The structure for remuneration of executives would be:

- Overview/summary—a description of the remuneration framework, key details of approaches to incentive payments and any additional one-off payments, as well as details of any expected reviews or changes to future remuneration.
- Remuneration strategy—including a discussion of objectives, quantum and the mix of remuneration components (fixed pay, short- and long-term incentives).
- Short-term incentives—a description of the plan, including discussion of performance metrics (as they operate) and details of any equity grants.
- Long-term incentives—a description of the plan(s), including discussion of performance metrics (as they operate), vesting schedules and details of equity grants.
- Contractual arrangements—such as notice periods, sign-on arrangements, termination entitlements (including those paid out in the current year) and details of any guaranteed payments.
- Remuneration outcomes—‘actual’ pay data for current and previous years.
- Performance and reward link—including rationale for the selection of performance hurdles, current short- and long-term incentive payments relative to maximum opportunity and rationale, historical short- and long-term incentive payments relative to key financial measures and rationale, and changes in executives’ shareholdings in the company.

For non-executive directors:

- Non-executive director policy and outcomes—a description of the remuneration framework (including base directors’ fees, committee fees and fee sacrifice schemes), noting any changes to the framework. This section would also include ‘actual’ pay data for current and previous years.

Under the Ernst and Young proposal, other details would be moved to the financial report—for example, the accounting values of remuneration for key management personnel (which would be aggregated, rather than individually reported as now), and a description of the methodology used to value equity-based payments. A key appeal of this approach is that ‘the removal of complex accounting disclosures would make it easier to use plain English throughout the [remuneration] report’ (Ernst and Young, sub. DD136, p. 2).

Ernst and Young notes that mandating the structure of remuneration reports would likely be impractical. Instead, it suggests changes to the Corporations Act and Corporations Regulations to remove unnecessary disclosure requirements, modify potentially beneficial requirements, and to add new requirements (table 8.1).

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<sup>101</sup> Annex to Chapter 8, pp 273-276.

**Redrafting section 300A of the Corporations Act**

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed a ‘simplification’ of section 300A of the Corporations Act (subs. DD168 and DD170). Under their proposed redrafting of section 300A, the Corporations Act would require that remuneration reports contain a plain English summary of remuneration policies and the remuneration for each member of the key management personnel. The details of these arrangements would be transferred to regulation 2M.3.03 of the Corporations Regulations.

**Table 8.1 Proposed changes to disclosure requirements**

	<i>Suggested change</i>
<b>Remove</b>	<ul style="list-style-type: none"> <li>• methods used to assess performance conditions</li> <li>• minimum and maximum values of bonuses and share-based awards in future periods</li> <li>• accounting disclosures regarding options (value of options exercised during the year, value of awards lapsed during the year, percentage of remuneration consisting of options)</li> <li>• description of long-term incentive plans that do not relate to current year grants</li> <li>• individual disclosures for the five highest paid executives if they are not key management personnel.</li> </ul>
<b>Modify</b>	<ul style="list-style-type: none"> <li>• description of performance and remuneration link</li> <li>• vesting percentages of bonuses and share-based payments</li> <li>• remuneration mix discussion</li> <li>• presentation of prior year individual remuneration data</li> <li>• share option and right disclosures.</li> </ul>
<b>Add</b>	<ul style="list-style-type: none"> <li>• actual remuneration outcomes</li> <li>• rationale for remuneration policy and mix</li> <li>• details of comparator groups and mechanisms to guard against ‘extreme’ incentive payments</li> <li>• termination payments disclosure.</li> </ul>

Source: Ernst and Young (sub. DD136).

Under regulation 2M.3.03, the plain English summary would be designed to inform shareholders about:

- the use of fixed remuneration, short- and long-term incentives, and how they relate to the company’s performance
- the use of comparator groups for benchmarking remuneration
- whether incentive schemes had been subject to any sensitivity analysis (measuring under what circumstances ‘excessive’ pay levels might emerge)
- how remuneration levels might be tempered in the event of ‘extreme outcomes’ resulting from formula-based contractual obligations (that is, how ‘excessive’ pay levels might be restrained should unexpected outcomes emerge)
- who is responsible for setting and implementing remuneration policies
- how the policies are evaluated, and against what criteria
- how aligned the policies are with the company’s risk profile.

Disclosure of remuneration levels would cover:

- ‘realisable’ remuneration during the reporting period, including:
  - what proportion of the ‘realisable’ remuneration resulted from fixed pay, vested incentives or termination benefits
  - a description of any performance hurdles or other vesting conditions
- payments granted (reported fair value at grant date), including:
  - a description of any performance hurdles or other vesting conditions
- total shareholdings.

Remuneration levels would continue to be reported in tables, for which Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan proposed standardised formats (box 8.14).

Arguing that section 300A of the Corporations Act had been ‘corrupted’ since it was introduced in 1998, Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan also proposed that an expert panel be established to monitor the ongoing operation of, and advise on any future amendments to, both section 300A and regulation 2M.3.03.

**Box 8.14 Presentation of remuneration**

Allens Arthur Robinson, Guerdon Associates, CGI Glass Lewis and Regnan suggested how tables should be used to present remuneration levels (sub. DD168, pp. 4–5).

**‘Realisable’ remuneration**

Name	Position	Total amount of realisable remuneration
...	...	...

**Grant date fair value**

Name	Position	Fixed rem.	Short-term incentives	Long-term incentives	Termination benefits	Other benefits	Total rem.
...	...	...	...	...	...	...	...

**Total shareholdings**

Name	Position	Total shareholding
...	...	...





## 4 ASX Corporate Governance Council

*This chapter outlines the approach adopted by the ASX Corporate Governance Council to the role of the remuneration committee of the board of listed entities and the content of executive remuneration arrangements.*

### 4.1 Introduction

The Australian Securities Exchange (ASX) Corporate Governance Council *Principles and Recommendations* apply to all listed entities and operate under an ‘if not, why not’ reporting requirement.<sup>102</sup> This flexible approach allows boards to develop policies and objectives appropriate for their individual circumstances.

Principle 8 states that:

Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear.

The Council observes that:

The awarding of remuneration is a key area of focus for investors. When setting the level and structure of remuneration, a company needs to balance its desire to attract and retain senior executives and directors against its interest in not paying excessive remuneration. It is important that there be a clear relationship between performance and remuneration, and that the policy underlying executive remuneration be understood by investors.

### 4.2 Remuneration committee

Recommendation 8.1 is that the board should establish a remuneration committee. From January 2011, there will be a requirement that the committee comprise a majority of independent directors, chaired by an independent director, and with at least three members.<sup>103</sup>

The commentary to the recommendation deals with the purpose, charter, composition and responsibilities of the remuneration committee. It also states that:

the company should design its remuneration policy in such a way that it:

- motivates senior executives to pursue the long-term growth and success of the company
- demonstrates a clear relationship between senior executives’ performance and remuneration.

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<sup>102</sup> ASX Listing Rule 4.10.3.

<sup>103</sup> ASX Media Release, 30 June 2010. The PC recommended, and the Government supported in principle, this change: *Australian Government Response To the Productivity Commission’s Inquiry on Executive Remuneration in Australia* (April 2010), p 5 (response to Recommendation 2 of the PC report). Also, the Government supported in principle the PC recommendation that the ASX listing rules prohibit executives in ASX300 companies from sitting on remuneration committees: p 5 (response to Recommendation 3 of the PC report).

Also:

The remuneration committee may seek input from individuals on remuneration policies, but no individual should be directly involved in deciding their own remuneration.

#### 4.3 Remuneration arrangements

Recommendation 8.2 is that companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives.

The accompanying commentary to this recommendation states that:

Executive directors' and senior executives' remuneration packages should involve a balance between fixed and incentive pay, reflecting short and long-term performance objectives appropriate to the company's circumstances and goals.

Box 8.1 sets out guidelines for executive remuneration packages, as follows:

Most executive remuneration packages will involve a balance between fixed and incentive pay. Companies may find it useful to consider the following components in formulating packages:

**1. Fixed remuneration** This should be reasonable and fair, taking into account the company's legal and industrial obligations and labour market conditions, and should be relative to the scale of business. It should reflect core performance requirements and expectations.

**2. Performance-based remuneration** Performance-based remuneration linked to clearly specified performance targets can be an effective tool in promoting the interests of the company and shareholders. Incentive schemes should be designed around appropriate performance benchmarks that measure relative performance and provide rewards for materially improved company performance.

**3. Equity-based remuneration** Appropriately designed equity-based remuneration, including stock options, can be an effective form of remuneration when linked to performance objectives or hurdles. Equity-based remuneration has limitations and can contribute to 'short-termism' on the part of senior executives. Accordingly, it is important to design appropriate schemes. The terms of such schemes should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes. The exercise of any entitlements under these schemes should be timed to coincide with any trading windows under any trading policy established by the company.

**4. Termination payments** Termination payments, if any, for chief executive officers should be agreed in advance, including detailed provisions in case of early termination. There should be no payment for removal for misconduct. Agreements should clearly articulate performance expectations. Companies should consider the consequences of an appointment not working out, and the costs and other impacts of early termination.

Box 8.2 sets out guidelines for non-executive director remuneration, as follows:

Companies may find it useful to consider the following when considering non-executive director remuneration:

1. Non-executive directors should normally be remunerated by way of fees, in the form of cash, non-cash benefits, superannuation contributions or salary sacrifice into equity; they should not normally participate in schemes designed for the remuneration of executives.

2. Non-executive directors should not receive options or bonus payments.
3. Non-executive directors should not be provided with retirement benefits other than superannuation.

#### 4.4 Reporting remuneration information

Under Recommendation 8.3, and the accompanying Guide to reporting on Principle 8, companies should provide certain information in the corporate governance statement in the annual report, including:

- the existence and terms of any schemes for retirement benefits, other than superannuation, for non-executive directors
- an explanation of any departures from Recommendations 8.1, 8.2 or 8.3.

Also, certain information should be made publicly available, ideally by posting it on the company's website in a clearly marked corporate governance section, including:

a summary of the company's policy on prohibiting entering into transactions in associated products which limit the economic risk of participating in unvested entitlements under any equity-based remuneration schemes.



## 5 Australian Prudential Regulation Authority

*This chapter outlines APRA standards and practice guidance on executive remuneration arrangements for financial institutions, including the structure of remuneration incentives.*

### 5.1 Introduction

The Australian Prudential Regulation Authority (APRA) regulates financial institutions, being banks, credit unions, building societies, general insurance and reinsurance companies, life companies, friendly societies, and most members of the superannuation industry. APRA focuses on the prudential regulation of these institutions, which, in other respects, are also subject to regulation by ASIC.

APRA has developed governance standards and guidance on executive remuneration arrangements for regulated institutions. The APRA standards and guide, published in November 2009 and operative in April 2010, are set out in:

- *Prudential Standard GPS 510 Governance, Prudential Standard APS 510 Governance and Prudential Standard LPS 510 Governance*
- *Prudential Practice Guide PPG 511—Remuneration*, which is designed to support financial institutions in complying with the prudential standards.

The APRA documents relate to managing or limiting risk incentives associated with remuneration arrangements for executives of these entities. They deal with the structure of these remuneration arrangements and their disclosure.

The requirements are closely aligned with the Financial Stability Board's *Principles for Sound Compensation Practices* (April 2009) and *Principles for Sound Compensation Practices—Implementation Standards* (September 2009).<sup>104</sup> These documents are further outlined in Section 10.2.

The standards and the guide require regulated institutions to:

- establish a board remuneration committee, with guidance by APRA on the composition and functioning of that committee
- develop a remuneration policy, with guidance by APRA on the matters to be taken into account in that policy
- provide the remuneration policy to APRA if requested and attest compliance in the risk management declaration submitted annually to APRA.

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<sup>104</sup> APRA PPG 511, **About this guide** para 2. See also para 1 of the main part of the guide.

APRA notes that its requirements:

are not intended to prescribe business decisions regarding pay levels or limit innovative methods of rewarding staff, provided such measures do not compromise the requirements of the prudential standards.<sup>105</sup>

## 5.2 Board remuneration committee

### 5.2.1 Composition of committee

Regulated institutions must generally have a board remuneration committee with at least three members, with all being non-executive directors and a majority (as well as the chair) being independent<sup>106</sup> (though the board has ultimate responsibility for remuneration<sup>107</sup>).

The APRA requirements make provision for corporate groups.<sup>108</sup>

### 5.2.2 Sources of information and advice

#### *Committee's own expertise*

The board remuneration committee should collectively have experience in setting remuneration and sufficient industry knowledge to allow for effective alignment of remuneration with prudent risk-taking.<sup>109</sup>

The board remuneration committee needs to exercise its own judgment and not rely solely on the judgment or opinions of others.<sup>110</sup>

#### *Advice from within the institution*

A board remuneration committee would typically seek information from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit and should have processes to ensure that advice from such parties is not influenced by conflicts of interest.<sup>111</sup>

<sup>105</sup> PPG 511 para 2.

<sup>106</sup> GPS 510 paras 48-49, APS 510 paras 47-48, LPS 510 paras 44-45, PPG 511 paras 4, 5. APRA may give an exemption from this requirement in exceptional circumstances: GPS 510 para 48, APS 510 para 47, LPS 510 para 44, PPG 511 paras 5, 90. However, there must be equivalent arrangements: PPG 511 paras 5-6.

The committee must:

- have a written charter and terms of reference that outline the Committee's roles, responsibilities and terms of operation
- be provided with the powers necessary to enable it to perform its functions (GPS 510 para 50, APS 510 para 49, LPS 510 para 46).

The powers of the committee must include free and unfettered access to risk and financial control personnel and other parties and power to engage third party experts in a manner that ensures that the engagement, including any advice received, is independent: GPS 510 para 52, APS 510 para 51, LPS 510 para 48, PPG 511 para 19.

For the arrangements to be adopted by foreign companies instead of a board remuneration committee, see GPS 510 para 54, APS 510 para 53, LPS 510 para 50.

<sup>107</sup> PPG 511 para 4, which also observes that the board should ensure that executive directors are not placed in a position of actual or perceived conflict of interest.

<sup>108</sup> GPS 510 para 53, APS 510 para 52, LPS 510 para 49, PPG 511 para 14.

<sup>109</sup> PPG 511 para 13.

<sup>110</sup> PPG 511 para 19.

<sup>111</sup> PPG 511 para 15.

### ***External advice***

The board remuneration committee may rely on administrative support from external parties when conducting reviews,<sup>112</sup> but, to avoid conflicts of interest, should not engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution.<sup>113</sup>

### **5.2.3 Responsibilities of committee**

#### ***Review of remuneration policy***

The board remuneration committee must conduct regular reviews of, and make recommendations to the board on, the remuneration policy, to ensure that it remains appropriate for its intended purpose.<sup>114</sup>

As part of this review, the committee would be expected to identify:

- material deviations of remuneration outcomes from the intent of its policy
- unreasonable or undesirable outcomes that flow from existing arrangements.<sup>115</sup>

The board remuneration committee should conduct a thorough risk-oriented assessment of all equity-related, profit-related and value-related remuneration components, with particular attention to the length of the deferral periods, to encourage executives to maintain a long-term view, even when approaching the end of their period of employment.<sup>116</sup>

#### ***Recommendations on remuneration***

The board remuneration committee must make annual recommendations to the board on the remuneration of:

- various individuals, being the chief executive officer (CEO), those who report directly to the CEO, other persons whose activities may affect the financial soundness of the institution and any other person specified by APRA.<sup>117</sup> These recommendations must relate to each individual<sup>118</sup>
- the categories of persons covered by the remuneration policy (other than the individuals covered by the previous dot point).<sup>119</sup> This will usually require decisions on the annual distribution of the institution's bonus pool.<sup>120</sup>

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<sup>112</sup> PPG 511 para 15.

<sup>113</sup> PPG 511 para 20.

<sup>114</sup> GPS 510 para 51(a), APS 510 para 50(a), LPS 510 para 47(a), PPG 511 paras 8. APRA generally expects a review to be undertaken at least every three years: PPG 511 para 10.

<sup>115</sup> PPG 511 para 8.

<sup>116</sup> PPG 511 para 79.

<sup>117</sup> GPS 510 para 51(b), APS 510 para 50(b), LPS 510 para 47(b). For larger institutions it may be appropriate to include a range of executives from the level below those who report directly to the CEO, as well as senior executives of material subsidiaries: PPG 511 para 11.

<sup>118</sup> PPG 511 paras 11, 28.

<sup>119</sup> GPS 510 para 51(c), APS 510 para 50(c), LPS 510 para 47(c).

<sup>120</sup> PPG 511 para 12.

In designing remuneration arrangements, the board remuneration committee should consider:

- the balance between fixed (salary) and variable (performance-based) components of remuneration. Performance-based components include all short-term and longer-term incentive remuneration, payable with or without deferral
- whether cash or equity-related payments are used and, in each case, the terms of the entitlements, including vesting and deferral arrangements.<sup>121</sup>

### 5.3 Remuneration policy

#### 5.3.1 Introduction

APRA requires regulated institutions to have a formal written remuneration policy approved by the board.<sup>122</sup> While the contents of such a policy will vary between institutions (in particular, APRA acknowledges that large, publicly-listed institutions will likely have more comprehensive policies than smaller, less complex unlisted institutions<sup>123</sup>), factors that are expected to be covered in that policy include:

- how remuneration is adjusted for risk
- how performance is measured (and how these outcomes are reviewed over time)
- the mix of fixed and incentive-based pay
- how ‘extreme outcomes’ are addressed—particularly where the financial soundness of the institution is threatened, but also in other circumstances (such as unexpected losses or reputational damage)
- the link between pay and performance, with specific regard to:
  - equity-based payments (and deferral of rewards)
  - executive lending and leveraging arrangements
  - sign-on bonuses and termination payments
  - hedging policies
  - perquisites.

The APRA requirements make provision for corporate groups.<sup>124</sup>

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<sup>121</sup> PPG 511 para 44.

<sup>122</sup> GPS 510 para 34-35, APS 510 para 33-34, LPS 510 para 30-31. Each prudential standard makes special provision for foreign companies; see also PPG 511 paras 17-18, 25-26.

<sup>123</sup> PPG 511 para 21.

<sup>124</sup> GPS 510 para 45, APS 510 para 44, LPS 510 para 41, PPG 511 paras 7, 23-24.



### 5.3.2 Persons covered by the policy

The policy must identify the persons to be covered, who must include the following:

- *executive directors and senior managers*<sup>125</sup>
- *risk and financial control personnel (including risk management, compliance, internal audit, financial control and actuarial control roles).*<sup>126</sup> This group requires special attention because of the potential conflict between their own interests and the interests of executives and others whose financial and risk performance they are required to monitor,<sup>127</sup> as well as the key role of these persons in ensuring the integrity of measurements and judgments taken into account in determining the risk-based aspects of remuneration<sup>128</sup>
- *all other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution.*<sup>129</sup> Such persons would typically include, but not be limited to, financial market traders, other transaction-oriented staff, commissioned sales personnel and intermediaries such as agents and brokers.<sup>130</sup>

### 5.3.3 Content of policy

The policy must outline:

- the remuneration objectives
- the structure of the remuneration arrangements, including the performance-based remuneration components.<sup>131</sup>

Remuneration arrangements include:

- measures of performance
- the mix of forms of remuneration, such as base (or fixed) and variable (or performance-based) components, and cash and equity-related benefits: base pay

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<sup>125</sup> GPS 510 para 40(a), APS 510 para 39(a), LPS 510 para 36(a). See also the definitions and discussion of:

- ‘responsible person’ in the APRA documents GPS 520 *Fit and Proper* paras 10-16, APS 520 *Fit and Proper* paras 8-14, APG 520 *Fit and Proper* paras 4-11, LPS 520 *Fit and Proper* paras 8-14
- ‘senior manager’ in GPS 520 paras 17-20, APS 520 paras 15-16, LPS 520 paras 15-16. The term ‘senior manager’ covers persons who have significant decision-making responsibilities, the capacity significantly to affect financial standing, or responsibility for substantial parts of the regulated institution’s business.

<sup>126</sup> GPS 510 para 40(b), APS 510 para 39(b), LPS 510 para 36(b).

<sup>127</sup> PPG 511 para 27(b).

<sup>128</sup> PPG 511 para 38.

<sup>129</sup> GPS 510 para 40(c), APS 510 para 39(c), LPS 510 para 36(c). APRA PPG 511 para 30 states:  
The determination of whether or not the variable proportion of a person’s remuneration is significant will vary according to the context, which will include, inter alia, the circumstances of the institution, the role of the individual concerned and the institution’s risk management controls and remuneration practices. APRA is not intending to define ‘significant’ but expects institutions to undertake their own assessments of significance on the basis of the circumstances and the remuneration arrangements of the institution.

APRA may also determine in writing that an individual or class of individuals must be covered by the remuneration policy: GPS 510 para 42, APS 510 para 41, LPS 510 para 38. PPG 511 para 31 states that:

APRA is likely to use this power only if there is material disagreement between the institution and APRA regarding the coverage specified in its Remuneration Policy.

<sup>130</sup> PPG 511 para 27(c).

<sup>131</sup> GPS 510 para 34, APS 510 para 33, LPS 510 para 30. The requirement to have a written remuneration policy applies even if a regulated institution has few or no performance-based components of remuneration: PPG 511 para 22.

should comprise a sufficient proportion of total remuneration to enable the board to make performance-based components genuinely discretionary

- the timing of eligibility to receive payments.<sup>132</sup>

The policy must form part of the regulated institution's risk management framework.<sup>133</sup>

Boards should seek a balance between offering incentives for good performance and avoiding incentives to take risks that are outside the regulated institution's risk appetite.<sup>134</sup>

### ***Base pay***

Components of base pay are usually base salary, superannuation and retirement benefits, and perhaps reimbursement of some kinds of expenses.<sup>135</sup>

### ***Performance-based components***

The performance-based components of remuneration must:

- be designed to encourage behaviour that supports the regulated institution's long-term financial soundness and risk management framework<sup>136</sup>
- be designed to align remuneration with prudent risk-taking<sup>137</sup>
- incorporate adjustments to reflect the outcomes and risks of business activities and the time necessary for reliable measurement of the outcomes.<sup>138</sup>

The policy must provide for the board to adjust performance-based components of remuneration downwards, to zero if appropriate, if necessary to protect the regulated institution's financial soundness or respond to significant unexpected or unintended consequences that were not foreseen by the remuneration committee.<sup>139</sup> Also, APRA expects the board to retain a discretion to modify unwarranted remuneration flowing from extreme formula-based bonus calculations.<sup>140</sup>

### ***Performance thresholds and targets***

Performance thresholds and targets should generally be set before the start of a performance period. Performance-based remuneration components such as performance

<sup>132</sup> GPS 510 para 36, APS 510 para 35, LPS 510 para 32, PPG 511 paras 68-69.

<sup>133</sup> GPS 510 para 46, APS 510 para 45, LPS 510 para 42, PPG 511 paras 16, 42-44. PPG 511 para 16 states:  
Effective coordination between the Board Risk Committee and the Board Remuneration Committee will assist in producing a properly integrated approach to remuneration.

PPG 511 para 42 states:

Generally speaking, if the risk management framework is effective, the risk-taking incentives provided by remuneration systems are mitigated and would be more likely to remain within the institution's risk tolerance.

<sup>134</sup> PPG 511 para 69. PPG 511 para 67 states:

A prudent overall remuneration structure, including the balance and selection of components of remuneration, would promote a culture and working environment that attract and encourage staff who fit a regulated institution's risk appetite.

<sup>135</sup> PPG 511 para 68.

<sup>136</sup> GPS 510 para 37, APS 510 para 36, LPS 510 para 33, PPG 511 para 4.

<sup>137</sup> GPS 510 para 38, APS 510 para 37, LPS 510 para 34. Also, PPG 511 para 76 states that:

it is sound practice to structure the components of performance-based remuneration in a way that aligns financial incentives for these executives with long-term, successful stewardship of the institution.

<sup>138</sup> GPS 510 para 38, APS 510 para 37, LPS 510 para 34. PPG 511 paras 70-72 discuss adjusting financial performance measures for risk.

<sup>139</sup> GPS 510 para 39, APS 510 para 38, LPS 510 para 35, PPG 511 paras 73-75.

<sup>140</sup> PPG 511 para 75.

hurdles and strike prices should not be reset due to company, industry, economic or share market adverse performance. Any variation from this approach in exceptional circumstances should require explicit support from the board remuneration committee and the board.<sup>141</sup>

### ***Deferral of payments***

A substantial portion, preferably a majority, of performance-based remuneration should be deferred and remain ‘at risk’ for an extended period until the regulated institution and its board can assess the consequences of the risks to which the institution has been exposed and thereby validate a person’s performance. This is particularly relevant where there are uncertainties in the accounting measures applicable to the period in which business is written or generated (for instance, assessing the repayment prospects of loans written during the current year).<sup>142</sup> The board should determine the amounts deferred, the length of the deferral periods and any associated vesting arrangements.<sup>143</sup> If there is no deferral, there should be a discount for measurement uncertainty.<sup>144</sup>

APRA recognised that:

Some business lines require many years of exposure before all risks have materialised. Long deferral periods, however, reduce the effectiveness of employee incentive arrangements. Hence, the Remuneration Policy needs to strike a reasonable balance between providing effective incentives and validating the performance measures over a deferral period.<sup>145</sup>

Factors to consider in deciding whether to defer remuneration include:

- deferral of equity components exposes employees to losses in the event of poor share price performance<sup>146</sup>
- the vesting of interest allocated on deferred cash payments, or dividends on deferred equity allocations, should occur no earlier than when the performance-based remuneration is validated<sup>147</sup>
- partial vesting of a deferred amount may be necessary to cover taxation obligations of the employee arising from the deferred component (such arrangements should be adequately documented in the remuneration policy)<sup>148</sup>
- partial vesting may cause administrative problems: for instance, an institution may have to attempt to recoup released funds from an ex-employee who has left the institution without vesting having occurred<sup>149</sup>

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<sup>141</sup> PPG 511 para 65.

<sup>142</sup> PPG 511 paras 54-56, 59. APRA in PPG 511 para 58 recognises that:

For some business activities that have strong controls in place and have well understood risks, it may be the case that performance can be reliably measured immediately.

<sup>143</sup> PPG 511 para 59.

<sup>144</sup> PPG 511 para 57.

<sup>145</sup> PPG 511 para 60.

<sup>146</sup> PPG 511 para 61.

<sup>147</sup> PPG 511 para 62.

<sup>148</sup> PPG 511 para 63.

<sup>149</sup> PPG 511 para 64.

- it is not prudent for deferred payments to vest automatically upon cessation of employment with a regulated institution (though failure to vest may cause tax problems).<sup>150</sup>

### *Measuring performance*

The measurement and allocation of performance-based remuneration based on accounting standards would generally be the starting point for financial measures of performance.<sup>151</sup> However:

- *exclusion or modification of measures outside individual control:* profit and value measures that are outside the control of individuals (for instance, changes in the values of assets that are marked-to-market or changes to the surplus or deficit of a defined benefit superannuation fund) may need to be excluded or modified in making remuneration assessments (provided that this is properly documented and substantiated)<sup>152</sup>
- *adjustment for risk:* performance targets and the measurement of actual performance against those targets should be adjusted for risk (including risk to which the regulated institution is exposed by an individual in performing his or her role), as financial measures of performance based mainly on revenue, volume or market share growth may provide an incentive to pay insufficient regard to risks, including future risks not identified or measured by accounting profits<sup>153</sup>
- *non-financial measures:* remuneration should be adjusted for non-financial measures, such as:
  - compliance with risk management and internal audit frameworks
  - management of staff
  - adherence to corporate values and displaying acceptable corporate citizenship.<sup>154</sup>

Mechanisms to identify performance against risk-related non-financial measures include:

- internal or external audit findings
- risk management assessments including any compliance breaches, unexpected taxation or litigation consequences, or administrative, civil or criminal actions taken against the institution.<sup>155</sup>

Measures such as relative total shareholder return (TSR), which rely on performance relative to other sources, should be used in conjunction with other performance measures, as strategies such as increasing leverage can be devised to boost TSR during the

<sup>150</sup> PPG 511 para 66.

<sup>151</sup> PPG 511 para 50.

<sup>152</sup> PPG 511 para 50.

<sup>153</sup> PPG 511 paras 46-48, 51, 54. PPG 511 para 51 states that:

A prudent policy will require that performance-based remuneration is low, perhaps zero, where the individual has been found to have exposed the institution to risk beyond its risk appetite or controls.

<sup>154</sup> PPG 511 para 53.

<sup>155</sup> PPG 511 para 53.

performance period, to the detriment of the longer-term soundness of the regulated institution.<sup>156</sup>

### ***Incoming payments***

Payments made to persons as an incentive to join a regulated institution should be subject to performance validation or risk adjustment and deferral, notwithstanding competition in recruiting: companies should be able to reduce ‘at risk’ remuneration if material adverse outcomes occur.<sup>157</sup>

### ***Terminating payments***

Regulated institutions should place suitable deferral and performance hurdles on terminating payments, as accelerated or unusually large payments to terminating executives may expose an institution to considerable risk, for instance, where an executive takes ‘large risks with the institution’s financial position in the knowledge that success would lead to large performance-based payments, and failure will lead to large termination payments’.<sup>158</sup>

### ***Equity-related components***

Having equity-related benefits, vested over an extended period, as a sizeable component of the deferred component of remuneration can encourage longer-term risk stewardship on the part of executives by increasing the incentives for an executive to preserve and enhance the value of the institution (though share prices can be affected by factors beyond the control of executives).<sup>159</sup>

Options may increase the incentives for executives to add volatility to a regulated entity’s business model or balance sheet, as the executives receive very high payments when market prices rise, representing a geared return relative to shareholders, but, when market prices fall and the option value becomes zero, shareholders and ultimately creditors may suffer losses whereas the executive has no further downside risk from the options.<sup>160</sup>

Executive directors and senior managers must be prohibited from hedging their equity-linked remuneration.<sup>161</sup>

### ***Payments to non-employees***

Payments to individual non-employees should conform to the remuneration policy of the regulated institution.<sup>162</sup>

Employees of a related body corporate who provide services to a regulated institution are to be treated as employees of the regulated institution.<sup>163</sup>

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<sup>156</sup> PPG 511 para 52. See also the discussion at paras 80-81 of the prudential concerns that may arise from companies offering leveraged equity ownership arrangements such as partly paid shares or shares funded by a concessionally priced loan.

<sup>157</sup> PPG 511 paras 82-83.

<sup>158</sup> PPG 511 paras 82, 84.

<sup>159</sup> PPG 511 para 77.

<sup>160</sup> PPG 511 para 78.

<sup>161</sup> GPS 510 para 43, APS 510 para 42, LPS 510 para 39. The remuneration policy must specify the actions to be taken where a person is found to have breached this requirement. See also PPG 511 paras 29, 85-87. APRA suggests that a regulated institution might also consider whether this anti-hedging approach is appropriate for other staff who receive equity-related benefits as part of their remuneration: PPG 511 para 87.

<sup>162</sup> PPG 511 para 33.

<sup>163</sup> PPG 511 para 33.

The remuneration policy must cover service contracts with entities that are not related bodies corporate where:

- the primary role of the entities is to provide the regulated institution with risk management, compliance, internal audit, financial control or actuarial control services, or
- the services provided by the entities may affect the financial soundness of the regulated institution and a significant portion of their total payment is based on performance<sup>164</sup>

unless:

- the regulated institution's risk management framework deals explicitly with the structure of payments to entities of this kind and the risk that payment incentives can give rise to inappropriate behaviour, and
- a board committee has the responsibility for overseeing this risk.<sup>165</sup>

***Structure of remuneration of risk and financial control personnel not to compromise independence***

The policy must ensure that the structure of the remuneration of risk and financial control personnel, including any performance-based components, does not compromise the independence of these personnel in carrying out their functions.<sup>166</sup>

In particular:

- the proportion of fixed salary to performance-based remuneration may be higher than for personnel with profit centre responsibility<sup>167</sup>
- regulated institutions will normally use qualitative measures based on the quality and integrity of control functions to determine the performance of these personnel<sup>168</sup>
- the variable remuneration received by such personnel would generally not be predominantly determined by either the managers or the financial performance of the business areas they monitor<sup>169</sup>
- paying these persons bonuses based on the performance of the institution as a whole is acceptable provided there are processes, covering the measurement of financial results and the checks and balances applied in decision-making, to ensure that the performance outcomes are determined independently.<sup>170</sup>

***Fringe benefits***

These arrangements may raise prudential concerns when they comprise a substantial share of an executive's total remuneration or when they are unusually large or generous.<sup>171</sup> The

<sup>164</sup> The effect on financial soundness of third party contracts should be considered collectively, not contract by contract: PPG 511 para 35.

<sup>165</sup> GPS 510 para 41, APS 510 para 40, LPS 510 para 37, PPG 511 paras 33-37.

<sup>166</sup> GPS 510 para 44, APS 510 para 43, LPS 510 para 40, PPG 511 para 39.

<sup>167</sup> PPG 511 para 41.

<sup>168</sup> PPG 511 para 39.

<sup>169</sup> PPG 511 para 39.

<sup>170</sup> PPG 511 para 40.

<sup>171</sup> PPG 511 para 88.

remuneration policy should document the material perquisite arrangements for persons subject to that policy.<sup>172</sup>

#### 5.4 Compliance

The remuneration policy must be provided to APRA on request.<sup>173</sup> Also, compliance with APRA's remuneration requirements will need to be attested to in the Risk Management Declaration submitted annually to APRA.<sup>174</sup>

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<sup>172</sup> PPG 511 para 89.

<sup>173</sup> GPS 510 para 47, APS 510 para 46, LPS 510 para 43.

<sup>174</sup> PPG 511 para 4.





## 6 Private sector approaches

*This chapter outlines the approaches taken by various professional and industry bodies to the content of executive remuneration arrangements and suggestions on the most appropriate disclosure of these arrangements.*

### 6.1 Australian Institute of Company Directors

#### 6.1.1 Guidelines for remuneration arrangements

The Australian Institute of Company Directors (AICD) publication *Executive remuneration: Guidelines for listed company boards* (2009) points out that a core part of a board's activities involves appointing and managing the performance of an appropriate chief executive officer and overseeing the appointment of other senior executives. These activities require the establishment and maintenance of contractual and remuneration arrangements that are in the best interests of the company.

The AICD publication sets out guidance for companies concerning:

- the framework and processes for remuneration decision-making, including the role of the remuneration committee of the board and the use of independent expertise
- remuneration policies and terms in regard to various possible remuneration components, including short-term incentives (STIs) and long-term incentives (LTIs)
- the processes for ongoing review of remuneration arrangements
- other matters, including keeping abreast of market sentiment and good governance practices on remuneration and ensuring that remuneration packages are publicly defensible.

In relation to remuneration policies and terms, the publication recommends that directors:

- establish executive remuneration policies that set out the reasoning behind the various remuneration components and any relevant conditions
- ensure that remuneration is reasonable, having regard to the best interests of the company
- have an appropriate mix between base pay, short-term incentives and long-term incentives, where such components are included in remuneration packages
- link incentive elements of remuneration packages to appropriate performance measures in such a way that short-term imperatives of the company are pursued while the company's long-term interests are simultaneously promoted
- consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract
- examine executive remuneration in the context of other employment terms and other benefits that may be provided by the company

- do not have arrangements that promote excessive risk-taking or short-termism
- do not provide for additional payments beyond basic statutory entitlements (for example, accrued annual leave) where an executive's employment relationship is terminated for misconduct
- think about whether to have a discretionary bonus rather than a bonus that the board is contractually obliged to accrue, regardless of changed circumstances
- think about placing an upper limit on short-term and long-term incentive rewards, where such components exist, to minimise 'surprises' concerning markets, products and so on
- think about having arrangements whereby a percentage of a CEO's long-term equity incentive rewards is held for a period that extends beyond the term of the employment contract
- think about the range of metrics for boards to examine other than just comparative market data, such as the net benefit to the company of different remuneration levels, differences in the remuneration of the CEO and those who report directly to him or her.

The publication states that AICD:

is firmly of the view that executive remuneration should remain a matter for boards and that further regulation in this area is unnecessary and often counterproductive to the outcomes sought.

### 6.1.2 Reform proposals on remuneration disclosure

The AICD Position Paper No. 15 *Remuneration reports* (June 2010) takes the view that remuneration reports and the legislative requirements governing them have become unduly complex, place significant burden on companies and are of limited use to shareholders and other readers.

The AICD supports a principles-based approach to the remuneration report in lieu of the current prescriptive requirements, which would involve an overview of the key elements of the company's remuneration arrangements for key senior personnel, in four broad areas:

- the governance structures for determining the remuneration of key senior personnel;
- the company's remuneration philosophy and policies for key senior personnel
- the remuneration outcomes for key senior personnel in the reporting period (i.e. the remuneration received in the current year in 'actual pay' terms, with theoretical accounting valuations of remuneration being confined to the financial statements and accompanying notes); and
- the current entitlements of key senior personnel to future remuneration.

AICD does not support:

- a black letter law requirement for remuneration reports to be in 'plain English', or a mandated 'plain English summary'; or

- an increase in the number of detailed prescriptive requirements in addition to those that currently exist.

The AICD paper contains various recommendations to implement its preferred approach, including:

- remuneration disclosure requirements should be consolidated in s 300A of the Corporations Act and the Corporations Regulations<sup>175</sup>
- s 300A should be redrafted along the lines of the principles-based approach to the remuneration report<sup>176</sup>
- the remuneration report should only disclose details of the remuneration of 'key senior personnel'<sup>177</sup>
- discussion of the performance conditions attaching to remuneration may omit material that would otherwise be included but is likely to result in unreasonable prejudice to the company. If material is omitted the report must say so (cf s 299A(3))<sup>178</sup>
- the remuneration report should distinguish between the remuneration arrangements, outcomes and entitlements for non-executive directors and those for other key senior personnel<sup>179</sup>
- the discussion of the company's governance structures for determining the remuneration of key senior personnel should include various disclosures, including a summary of the checks and balances included in the decision-making process<sup>180</sup>
- the discussion of the company's remuneration philosophy and policies for key senior personnel should include the following disclosures:
  - a description of the company's guiding principles or approach in setting remuneration for key senior personnel
  - a summary of the key aspects of equity-based and other performance-based plans for key senior personnel
  - a summary of the performance conditions which attach to the remuneration of key senior personnel
  - a summary of the company's policy on hedging unvested and vested equity securities that form part of performance-based plans
  - an explanation of the link between the remuneration of key senior personnel and company performance<sup>181</sup>

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<sup>175</sup> Recommendation 1.

<sup>176</sup> Recommendation 2.

<sup>177</sup> Recommendation 4.

<sup>178</sup> Recommendation 3.

<sup>179</sup> Recommendation 5.

<sup>180</sup> Recommendation 6.

<sup>181</sup> Recommendation 7.

- the disclosure of the company's remuneration outcomes (in 'actual pay' terms) should be divided between:
  - fixed remuneration
  - cash bonuses
  - realisable equity
  - termination benefits
  - post-employment benefits
  - other benefits.

This information should be for the current and the previous reporting period<sup>182</sup>

- the discussion of the current entitlements of key senior personnel to future remuneration should include the following details:
  - the type of future remuneration and a summary of the performance conditions attaching to it as at the reporting date
  - agreed entitlements in the event the employment relationship is terminated
  - any changes that have occurred to the performance conditions in respect of current entitlements of key senior personnel to future remuneration since the last annual report and the date of alteration.

The company's discussion of the current entitlements to future remuneration need not include probability-based accounting valuations of any securities or equitable instruments<sup>183</sup>

- the disclosure of the holdings key management (senior) personnel have in the company's securities should not, as a matter of good governance practice, be included in the remuneration report<sup>184</sup>
- the requirement for the company auditor to provide an opinion as to whether the remuneration report complies with s 300A should be deleted from the Corporations Act.<sup>185</sup>

### ***Interaction with accounting standards***

The AICD indicated in Position Paper No. 15 that it had changed its previously held view that remuneration disclosure requirements should be consolidated in the accounting standards. It now considers that the Corporations Act and Regulations are the most appropriate places for consolidation.<sup>186</sup>

In the Position Paper, the AICD stated:

One of the key concerns raised by both preparers and users of Remuneration Reports is that the value of remuneration calculated in accordance with the Accounting

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<sup>182</sup> Recommendation 8.

<sup>183</sup> Recommendation 9.

<sup>184</sup> Recommendation 10.

<sup>185</sup> Recommendation 11.

<sup>186</sup> Footnote 18.

Standards and included in a company's financial statements often does not reflect the remuneration actually received by key management personnel and the five most highly remunerated executives during the period.<sup>187</sup>

In the AICD's view, 'there should not be any requirement to include probability-based accounting valuations in respect of future contingent payments'.<sup>188</sup>

A submission to the Productivity Commission inquiry expressed a comparable view regarding interaction with the accounting standards.<sup>189</sup>

A consulting firm has put forward an assessment of AICD Position Paper No. 15.<sup>190</sup>

## 6.2 Investment and Financial Services Association

The Investment and Financial Services Association (IFSA), a funds management industry body, publishes *Corporate Governance: A Guide for Fund Managers and Corporations* (the 'Blue Book'), which includes an analysis of what institutional investors expect of directors in regard to corporate governance structures. It is designed:

to assist [IFSA's members] to pursue an active role in monitoring the Corporate Governance responsibilities of the companies in which they invest.<sup>191</sup>

The IFSA guidelines are designed to complement the ASX Corporate Governance *Principles and Recommendations*.

Guideline 14 of the IFSA Blue Book (Board and Executive Remuneration Policy and Disclosure) states that:

The board must disclose in the company's annual report its policies on, and the quantum and components of, remuneration for all directors and each of the five highest paid executives. Where consolidated financial statements are required, remuneration details of each of the five highest paid group executives must be provided. The disclosure should be made in one section of the annual report in tabular form with appropriate explanatory notes.<sup>192</sup>

IFSA has the following additional guidance on this guideline:<sup>193</sup>

The board is required to disclose in the company's annual report a 'Remuneration Report' being:

- its policies on the remuneration of directors, the company secretary and senior managers of the company or consolidated entity;
- a discussion of its remuneration policy in the context of company performance over the current and four previous financial years;

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<sup>187</sup> Section 2.6.

<sup>188</sup> Section 2.7.

<sup>189</sup> The submission of Allens Arthur Robinson, cited at p 247 of the PC report, said that:  
[Remuneration disclosure] has been corrupted by linking it to accounting and other standards so that what has to be disclosed is both highly complex and, hence, difficult for even sophisticated investors to grasp and, especially in the case of equity based long term incentives, totally fails to provide an accurate and meaningful disclosure of what the executive has actually received for the year under report.

<sup>190</sup> Guerdon Associates News, *The AICD has a go at fixing remuneration report complexity* (23/06/2010).

<sup>191</sup> Section 7.1.

<sup>192</sup> IFSA Blue Book Section 8.2.14.

<sup>193</sup> Section 11.15.

- a discussion of remuneration performance hurdles, their rationale, selection and measurement; and
- the remuneration for all directors, each of the five highest paid executives and, where consolidated financial statements are required, the five highest paid group executives.

The *Corporations Act 2001* was amended in 2004 to expand company disclosure requirements for remuneration of directors and executive officers. Shareholders must be given a reasonable opportunity to comment and ask questions about the Remuneration Report, and to cast a non-binding vote on the adoption of the Report.

This Guideline, along with Guidance Note No. 12—Executive Equity Plan, addresses current shareholder concerns on remuneration practices in Australia. Its purpose is to provide shareholders with meaningful information on the application of the board's remuneration policies in the context of the performance of the company. The disclosures recommended recognise and promote the important principles of accountability, transparency and fairness.

IFSA Members consider that Australian listed companies must be able to attract and reward superior executives within a competitive global environment. Nevertheless, remuneration must be reasonable in light of the circumstances of the company and should be adequately disclosed to shareholders. Companies can assist in overcoming the perception that remuneration is overly generous by taking a leading role in disclosing all components of remuneration and the way in which executives are rewarded for performance.

In particular, appropriate disclosure will provide shareholders, in an easily understood format, with the information they need to know on the quantum and components of remuneration in comparison with the performance of the company and the stated policies of the board. It may be appropriate for boards to, at least indirectly, consider the impact that remuneration packages may have on the cohesiveness of the community in which their company operates.

All components of remuneration should be disclosed, including cash salary and bonuses, shares or options granted and any other long term payments or other compensation. Boards should pay particular attention to increasing the transparency of termination or retirement payments to directors and senior management. It is important that termination or retirement payments should be fully disclosed to shareholders and that they are reasonable in the circumstances of the departure. Section 200G of the *Corporations Act 2001* stipulates a requirement for shareholder approval for termination payments that exceed one year of the average salary for the previous three years of a director or executive officer.

A suggested format for this disclosure is illustrated in [an Appendix to the Blue Book]. Where shares or share options are issued, the company may find it useful to illustrate in graphical form the relevant performance criteria required to be achieved before they can be exercised.

This Guideline is reflected in ASX Principle 8: Remunerate fairly and responsibly.

#### *Share and Option Schemes*

IFSA supports the implementation of properly designed incentive schemes that have robust performance hurdles. The schemes must be fully disclosed and approved by shareholders.

Share and share option schemes can be an important element of well-designed remuneration packages. The granting of a right to equity participation, subject to appropriate performance hurdles, assists in aligning the interests of executives and shareholders. While the alignment of interests is important, shareholders need

adequate disclosure to ensure that the schemes are appropriately designed. Equity participation should not involve the provision by the company of non-recourse loans.

IFSA has two Guidance Notes on this issue: Guidance Note No. 12—Executive Equity Plan and Guidance Note No. 13—Employee Share Ownership Plan. These Guidance Notes were developed in conjunction with the AICD, the ASA and the Australian Employee Ownership Association. IFSA Members encourage all Australian listed companies to comply with these Guidance Notes.

Key principles within the Share and Share Option Scheme Guidelines are:

- all schemes should be disclosed to shareholders for their approval;
- remuneration should realistically reflect the responsibilities of executives;
- remuneration should be reasonable and comparable with market standards;
- incentive schemes must reward superior company performance and be clearly linked to appropriate performance benchmarks;
- performance hurdles must be based on specific benchmarks which assess actual company performance, for example, peer assessment in terms of long-term growth of the company and resulting shareholder value; and
- the cost of the schemes must be disclosed in accordance with the requirements of the law and relevant accounting standards.

IFSA Members do not consider that option schemes should be banned. A poorly designed share scheme is as unacceptable as a poorly designed option scheme. The Guidelines do not establish which type of incentive scheme a company should implement. Rather, it is important that boards develop incentive schemes which are appropriate for the circumstances of the company and which are aimed at driving superior executive performance.

The IFSA Guidelines are not intended to restrict or diminish the flexibility of companies to attract, retain and motivate employees in the interest of improved company performance. However, shareholders have a right to know the costs of such schemes and the success of these elements of remuneration measured against the original reasons for their use.

This Guideline is reflected in ASX Principle 8: Remunerate fairly and responsibly.

### 6.3 Australian Council of Superannuation Investors

The Australian Council of Superannuation Investors (ACSI) publishes various guidelines to provide superannuation fund managers with benchmarks to assess the relevant practices of companies in which they invest. Its *Governance Guidelines* (May 2009) set out statements of practice that ACSI believes Australian companies should follow in conducting their business. The guidelines are intended to supplement regulatory requirements.

Section 10.3 of the guidelines deals with the role and responsibilities of the remuneration committee, including:

- ensuring that the design and implementation of remuneration packages are linked to the company's performance objectives
- promoting clear and understandable remuneration methodologies that support superior performance and the long-term growth of shareholder value

- being responsible for preparing the remuneration disclosure report, which should be signed off by the board and included in the annual report.

Section 16 of the guidelines deal with executive remuneration. It provides:

Executive incentive arrangements provide a tangible insight into the effectiveness, or otherwise, of boards in attracting, retaining and motivating key management personnel. How executives are remunerated also provides investors with an insight into the relationship between the board and executives. Boards therefore have a primary role in establishing remuneration policy in order to attract and retain highly competent executives.

CEO's and senior executives influence the direction of companies, which ultimately affects shareholder return. Therefore, executive remuneration should promote superior performance of a company.

ACSI believes that boards should always be encouraged to put in place remuneration arrangements that reward success, not mediocrity or failure.

### **16.1 Remuneration practices**

- (a) ACSI recognises that boards have a critical role in attracting, retaining and motivating executives through remuneration policy. The overall size of remuneration should be reasonable but not excessive in order to achieve these objectives.
- (b) Remuneration reports provide an effective mechanism for investors to consider the remuneration policies of companies. In particular, the remuneration report enables shareholders to convey a view on those practices when casting a 'non binding' vote. The report should outline all key aspects regarding the determination of remuneration policy, in particular the linkage between the policy and performance in the interests of promoting long-term shareholder value.
- (c) In order to avoid overly legalistic and technical explanations that would appear to complicate good disclosure, ACSI encourages a narrative approach to remuneration reporting whereby companies use the remuneration report to explain why remuneration practices are appropriate for the company and those covered by the report.
- (d) The board should report the remuneration practices that are applicable to non-managerial employees, management employees and executives.
- (e) Because executives are responsible for influencing the direction of the company, which ultimately affects shareholder return, executive remuneration should promote superior performance of a company against comparable peer group(s) over the long-term. Executive remuneration has the potential to damage reputation, affect employee morale and affect behaviour. Getting the balance on time scale and appropriate performance measures is critical.
- (f) Executives should not derive significant remuneration benefits in the absence of a direct contribution to long-term superior financial performance of the company.
- (g) Remuneration should be regarded as a key tool to motivate executives and employees and harness their support of the long-term growth and success of the company.
- (h) In broad terms, a properly structured remuneration scheme for executives should:



- be reasonable in remunerating executives in a way which is aligned with shareholder interests
- strike a balance between shareholder and executive expectations, in particular with respect to determining the overall amounts of company profits to apply to executive compensation and reward
- be measurable against key corporate performance indicators
- be sufficiently market-oriented, within levels of comparability for similar peer group companies in the context of industry, size and business focus
- be properly and comprehensively described to shareholders including base cash remuneration, short-term bonuses and longer-term incentives or other rewards
- separately outline details relating to fixed remuneration, bonuses and incentives and share scheme arrangements
- be fully disclosed, valued and expensed in accordance with regulatory requirements, and
- be acceptable to shareholders.

## 16.2 Termination payments

- (a) When a company appoints a senior executive, ACSI acknowledges that ASX Listing Rule 3.1 requires the company to disclose the contractual terms (including termination conditions) of that appointment. As part of that disclosure, ACSI also encourages companies to include the potential value of the termination payout for the senior executive, in order to eliminate the element of surprise for shareholders in the future.
- (b) A company should disclose its policy on notice periods and termination payments in Executive Service Agreements. This includes reference to compensation provisions that are applicable upon the termination of an executive's employment. The relevant 'triggers' for termination that arise should be disclosed.
- (c) ACSI would support bringing Australian disclosure provisions relating to Executive Service Agreements in line with US provisions that compel listed companies to file a copy of Executive Service Agreements with the Securities and Exchange Commission (SEC) at the time a senior executive is hired. This ensures that the contractual provisions dealing with a potential termination payout are made public contemporaneously with the hiring of the executive. This will overcome the latitude that is currently available to Australian companies to disclose key details of Executive Service Agreements, such as termination provisions, as late as 15 months after the executive is hired—when the next annual report is published.
- (d) A company should ensure that an Executive Service Agreement provides a reasonable basis to procure the early termination of an executive where the executive has performed poorly and inadequately against previously agreed benchmarks.
- (e) Boards should therefore be discouraged from paying out excessive and unreasonable termination payments in circumstances where the termination is a consequence of poor and inadequate performance.
- (f) Properly constructed 'liquidated damages' clauses are one way of restricting payouts to executives who depart following a period of poor performance.

These clauses typically allow for termination payments even where the executive's performance has been below a required standard (though not so bad as to constitute dismissal for 'cause'), but the size of the payout is delimited in advance.

ACSI supports liquidated damages clauses in Executive Service Agreements that:

- provide a maximum liquidated damages payout of no more than 12 months' base salary, and
  - provide that no amount (other than statutory entitlements such as accrued leave) is payable where the executive is dismissed for cause, i.e. misconduct, wilful neglect or serious breach of the Executive Service Agreement.
- (g) In circumstances where an executive is dismissed for underperformance (not amounting to cause), the Executive Service Agreement should provide that all unvested performance and incentive-related elements of the executive's remuneration package are forfeited. There should be a clearly defined, and not excessive, time-frame during which vested options and other incentive instruments may be exercised, provided that performance hurdles have been satisfied prior to termination.
- (h) In circumstances where an executive is dismissed for cause, the Executive Service Agreement should provide that all performance and incentive-related elements of the executive's remuneration package are forfeited. This includes options and other incentive instruments that are unvested at the time of dismissal, and also options and other incentive instruments that have vested but have not been exercised at the time of dismissal.
- (i) ACSI supports the introduction of UK-style proposals that provide for the outstanding term of a contract to be paid in 'phased' termination payments that cease when an executive finds other employment.
- (j) ACSI supports legislative reform that would provide shareholders with a greater say on termination benefit payments. Existing caps currently applicable under sections 200F and 200G of the Corporations Act, that allow for shareholders' approval of termination payments that exceed seven-times annual remuneration are considered to be too generous. ACSI considers that termination benefits worth more than 12 months' base salary should require approval by shareholders.
- (k) Section 16.11 details ACSI's policy with regard to options and performance rights following retirement and resignation.

### **16.3 Disclosure, valuation and expensing of remuneration**

It is of critical importance that all elements of remuneration, including all fixed and variable components, are properly disclosed, valued and expensed. A company should ensure that it meets the various disclosure requirements arising out of the Corporations Act. This also includes the requirement to appropriately value remuneration arrangements under the Corporations Act.

### **16.4 Fixed remuneration**

- (a) Fixed remuneration is a component of the total compensation of all employees in the company. It should take into account legal, industrial and other obligations of the company.

- (b) In relation to executive remuneration, the fixed component of a remuneration package should be relative to the scale of business as measured by sales, assets, number of employees and total market capitalisation.
- (c) As a general rule fixed pay should not be so high that incentive elements are not regarded as remuneration 'at risk' by executives; nor so low as to impinge on the executive being able to meet his or her essential financial commitments.
- (d) General increases in fixed remuneration for executives should be considered in light of an executive's total remuneration and have regard to the rate of increases applicable to the rest of the company's workforce. The rationale behind a substantial increase in fixed remuneration for executives should be disclosed by the company including why substantial increases are warranted in light of both the circumstances of the company and the performance of the relevant executive.

#### **16.5 Variable remuneration**

- (a) Variable remuneration includes short-term incentives (such as an annual bonus) and long-term incentives (such as share options or share-based incentives).
- (b) All variable remuneration schemes should be provided in reasonable amounts, should generally be valued at a level that is a reasonable and explainable multiple of the executive's fixed remuneration and be underpinned by clear and relevant performance hurdles.
- (c) In general ACSI will not support amendments to variable remuneration which effectively lead to a 'de-risking' of executive pay. Where company performance and shareholder value has declined, executive incentives that are promoted as 'at risk' should generally also decline on a proportionate basis.

#### **16.6 Performance conditions for short-term incentive schemes**

- (a) With respect to annual bonuses that are usually paid in cash, these payments should be linked to clear key performance requirements and predetermined targets. Such requirements should generally be disclosed in the company's remuneration report subject to 'commercial in confidence' requirements.
- (b) Where commercial confidentiality applies, in accordance with the Corporations Act requirements, companies should disclose the parameters adopted in the financial year for the bonus arrangements or alternatively the conditions that apply retrospectively.

#### **16.7 Retention payments**

- (a) The remuneration policy and practices (including incentive arrangements) should adequately factor in retention mechanisms for executives.
- (b) If retention benefits or sign-on benefits (including golden handshakes) are made to executives, whether upon joining or during the executive's tenure, the benefits should be disclosed and subject to a holding lock of between one to three years.

#### **16.8 Performance conditions for long-term incentive schemes**

- (a) The performance conditions for long-term incentive schemes (e.g. share option plans and share-based incentive plans) should be designed to reward executives for contributing to long-term, above average corporate

performance. To ensure that executives are only rewarded for sustained risk adjusted performance, boards are encouraged to stress test proposed performance metrics.

- (b) Companies should explain how high levels of potential reward are tied to stretching and demanding performance conditions, particularly where a company makes an annual grant of options (or other long-term incentive awards) the value of which exceeds one times base salary.
- (c) ACSI encourages the utilisation of forward-looking dual performance hurdles which measure the company's performance on an absolute and relative basis, to be satisfied before any share options or other long-term incentive instruments vest.
- (d) An example of an 'absolute' measure of performance includes a company's earnings per share exceeding a target established by the board. In this regard, a target should be sufficiently demanding.
- (e) An example of a 'relative' performance measure is where the company's total shareholder return must place the company at a certain point in a ranking against an identified set of peers.
- (f) ACSI will, however, accept the utilisation of one performance hurdle, preferably a relative performance measure that is sufficiently challenging and requires the achievement of out-performance against relevant and disclosed external benchmarks.
- (g) In general, ACSI will not support remuneration schemes, or proposed grants of incentives under them, where performance hurdles are not sufficiently demanding. What will be regarded as sufficiently demanding is a case-by-case judgement; however, the following guidance is of general application:
  - where a relative hurdle is used, there should be no vesting unless the company's performance is ahead of at least half of peer companies
  - ACSI is generally supportive of hurdles which allow for 'variable reward'—under which the number of options (or other long-term incentive instruments) that vest increases on a sliding scale according to the level of corporate performance achieved
  - ACSI does not support hurdles that allow for all options (or other long-term incentive instruments) to vest for median, or slightly better than median, performance
  - where a share incentive scheme provides for 'performance rights', 'performance shares', 'deferred shares' and other zero exercise price options (zepos) with an exercise price of zero, it is particularly important that challenging performance hurdles are in place. This is because these instruments lack the inherent share-price appreciation hurdle that traditional options possess. ACSI in general would not consider an absolute accounting based hurdle stretching where the scheme provides zepos
  - performance hurdles need to be explained clearly—both in the annual report and also in the notice of meeting—when a grant of options (or other long-term incentive instrument) is put to shareholders for approval. Information about the hurdle needs to be sufficient in detail and clarity, to enable investors to determine whether it will allow for executives to be rewarded only if long-term corporate performance is enhanced

- ACSI is generally opposed to re-testing, but is prepared to assess each case on its merits, as detailed in Section 16.10, and
- performance hurdles are equally important for loan-funded share plans, as detailed in Section 16.13.

## 16.9 Other aspects of long-term incentive schemes

### (a) Types of schemes

- (i) companies may provide share option schemes for their executives or promote share incentive and reward schemes as an appropriate method of long-term variable remuneration
- (ii) although share incentive and reward schemes may not result in the same dilutive impact on existing shares as a share option arrangement, a share incentive scheme may in itself be unacceptable if it has insufficiently demanding performance hurdles
- (iii) share option schemes providing options in reasonable amounts and with challenging performance hurdles can still be regarded as a reasonable incentive for executives. The key considerations for option schemes are that they should have reasonable conditions of issue, be issued in reasonable quantities, and be properly disclosed, valued and expensed.

### (b) Frequency of grants

The board should ensure that grants of options (or other long-term incentive awards) are made regularly (e.g. annually) in preference to one large tranche every three or four years. This is designed to:

- reduce the risk of unanticipated outcomes that arise out of share price volatility and cyclical factors
- reduce the possibility that a limit on existing options encourages early exercise
- allow the adoption of a single performance measurement period, and
- reduce the possibility of 'underwater' options, where the share price falls below the exercise price.

### (c) Exercise price

- (i) the exercise price for options should not be less than the average of the share price on the five days of trading before the options are granted
- (ii) scheme rules should not be altered to make it easier for the executive to exercise options where there has been a fall in share price or performance (i.e. repricing of options and adjustment of targets)
- (iii) option scheme rules should not give the board, a board committee, or the plan administrator discretion to lower the exercise price of options that have already been awarded, where the market price of the shares has fallen below the original exercise price
- (iv) a company may bring about substantially the same result as repricing by granting a new tranche of options to its executives if last year's grant is now underwater. Some Australian companies

have replaced underwater options in this way in previous years. ACSI does not support this practice.

(d) Vesting period

- (i) grants of options and other long-term incentive instruments should incorporate a minimum vesting period of at least three years. However, in general ACSI has a preference for longer vesting periods
- (ii) where a scheme utilises phased vesting schedules, that is, where options or rights vest in tranches (e.g. one-third of options vest after three years; one-third vest after four years; and one-third vest after five years), then each tranche of awards should be linked to sustained performance requirements.

(e) Holding lock

A holding lock is a requirement that shares received on exercise of options, or after performance rights vest, must be retained for a further defined period of time. ACSI supports a holding lock period of between one to three years.

(f) Disclosure

The following information should be disclosed:

- the expiry date for options or other long-term incentive instruments, when a grant of options (or other long-term incentive instruments) is put to shareholders for approval
- the number of shares available or eligible for issue and actually issued under the option scheme or share-based incentive scheme
- the value and number of share options and shares granted, exercised and outstanding under all incentive plans, in accordance with the Corporations Act
- the value of those options or instruments where shareholder approval is being sought for a particular grant of options or other long-term incentive instruments
- the valuation method used to value options. In particular, any discount factor applied as part of the valuation (e.g. to take account of the possibility of performance hurdles not being satisfied in whole or in part, or to take account of executive leaving the company and surrendering options)
- the exercise price of share options (or the method of determining it), and
- the company's policy with regard to the treatment of dividend payments on unearned shares that form part of any long-term incentive scheme.

(g) Valuation and expensing

- (i) in relation to the requirement to value share options and other long-term incentive instruments, companies should utilise an internationally recognised method of valuation in order to meet the requirements of the Corporations Act and Accounting Standards
- (ii) grants made under share incentive and option schemes should be properly expensed in company financial statements in accordance with the appropriate accounting standards.

Boards should ensure that they are sufficiently apprised of the requirements of these standards and apply them accordingly in the relevant disclosure provisions in annual reports.

- (h) Dilution
  - (i) the dilutive impact of share option and share incentive plans on existing shareholders should not be excessive. This will generally depend on the value of options and shares issued and the position of the company, particularly whether it is a new and emerging company or one that is established and mature
  - (ii) ACSI's concerns with regard to dilution also apply to shares purchased on market using company funds on behalf of employees
  - (iii) in general, prior shareholder approval should be required where any single share or share option scheme could result in shares equal to 5% or greater of total issued ordinary shares being allocated. Generally, the total number of shares and options for executives and employees, under all schemes, should not exceed 10%. ACSI will consider, on a case by case basis, share and share option schemes that provide for a total potential dilution (under all the company's schemes) of up to 10%
  - (iv) ACSI will not support share or share option plans, or grants under those plans, where the 'flow rate' (i.e. the total number of options and shares granted in any one year, expressed as a percentage of total issued ordinary shares) exceeds 2%. ACSI will consider, on a case-by-case basis, plans, and grants under plans, where the flow rate exceeds 1% but is less than 2%. A flow rate of less than 1% is generally acceptable.

#### **16.10 Re-testing of performance hurdles**

Where performance conditions or hurdles have not been met at the vesting date, the ability to 'retest' the hurdle on a future date or dates is an unacceptable aspect of corporate governance in some countries. ACSI is generally opposed to re-testing, but is prepared to assess each proposal on a case-by-case basis.

#### **16.11 Options and performance rights following retirement or resignation**

- (a) Options (or other long-term incentive instruments) should be exercised within one year after retirement or otherwise they lapse. Performance conditions should not be waived.
- (b) ACSI will consider proposals that allow for a pro rata number of options/performance rights to be exercisable where the executive resigns from the company during the vesting period.
- (c) Section 16.2 details ACSI's policy in relation to the treatment of long-term incentives where an executive is dismissed for cause or for poor performance.

#### **16.12 Change of corporate control**

- (a) ACSI does not support the full vesting of options and performance rights in the event of a takeover or change of control in the company, irrespective of how far into the vesting period the options are and whether or not performance hurdles have been satisfied.

- (b) However, ACSI is prepared to consider the pro rata vesting of options/performance rights, to take into account any period of vesting that has accrued up until the time of change of control.

#### **16.13 Loan-funded share plans**

- (a) ACSI does not support loans to be made to executives on a non-commercial basis, so that they may take up shares.
- (b) With respect to non-recourse or limited recourse loans, ACSI supports share plans that provide that where shares are forfeited by an executive, the company is able to sell the shares on-market to recoup some or all of what was owed by the executive. In order to minimise a potential cash loss to a company ACSI prefers the use of newly issued shares in such schemes.
- (c) ACSI views loan-funded share plans as analogous to option plans, and therefore expects challenging performance hurdles to also apply to loan-funded share plans.

#### **16.14 Option hedging**

- (a) ACSI does not support companies allowing their executives to obtain financial products to remove the risk associated with share options in their remuneration package where they have not vested. This practice negates the rationale for variable remuneration schemes that should apply when an executive has contributed to above average corporate performance.
- (b) ACSI encourages companies to disclose if they have a policy in relation to option hedging and they are further encouraged to disclose when it is implemented.
- (c) In order that shareholders can make informed decisions based upon amongst other things, a director or executive's share trading and to ensure confidence in the integrity of the market, where a company permits directors and senior executives to hedge their vested incentives, the company should inform the market about the transaction within 2 days of it occurring.

#### **16.15 Director remuneration and share ownership**

- (a) All forms of remuneration paid to directors should be disclosed in accordance with Corporations Act and ASX Listing Rule requirements. Companies are encouraged to disclose the rationale for proposed aggregate non-executive director fee cap increases and how this will be apportioned to existing non-executive directors when an increase in the fee cap is being sought. ACSI expects that the fee cap will cover all fees paid to directors, including base fees, committee fees and superannuation.
- (b) Independent non-executive directors should be encouraged to acquire shares from an allocation of fees paid for undertaking their directorship.
- (c) ACSI does not support the creation of a retirement benefit plan for independent non-executive directors (excluding Superannuation Guarantee payments). Where, for historical reasons, a retirement benefit plan is in place ACSI would support companies freezing those benefits (with appropriate indexation).
- (d) All monetary arrangements with directors for services outside normal board activities should be approved by the remuneration committee of the board.



## 6.4 Australian Shareholders' Association

The Australian Shareholders' Association (ASA) has published a policy statement *Executive Remuneration* (March 2009), as follows.

### **Background**

Rates of increase in executive remuneration have accelerated over the past decade to such an extent that multi-million dollar packages have become commonplace in larger listed companies. The gaps between the pay of Australian CEOs and senior executives on the one hand, and other employees and the workforce in general on the other, have become huge and are the subject of increasing levels of valid criticism.

Retail shareholders have long been sceptical of the need for Australian CEOs to be remunerated with such increasing largesse. They have questioned the necessity, often claimed by boards, of having to meet international standards set by the two highest paying regimes of USA and UK. They view with suspicion the advice of "independent" remuneration consultants contracted by, and accountable to, those same boards. Retail shareholders have widely condemned the large termination payments granted to CEOs and others who have left their positions on retirement, resignation or sometimes following unsatisfactory performance. There is also increasing concern about high levels of short-term incentive payments and the potential for executives to focus on achieving short-term goals to the detriment of the longer-term interests of shareholders.

The structures of those components of remuneration packages which are classified as long-term and short-term incentive payments, often described as "at risk", have been challenged with some success and it is now the norm for payments to require preset performance hurdles to be met. Nevertheless, progress here has been modest and there remains a widespread view that incentive payments are too easily given for performance which is satisfactory only and by no means superior, and that these payments are neither earned nor well aligned with returns generated for shareholders.

Recent and current global financial turmoil and the accompanying massive diminution in shareholder wealth have reinforced the view that senior executive remuneration levels are excessive. Equally disturbing, in too many cases they have provided support to shareholders' conclusions that incentives embedded within remuneration structures are not well aligned with the interests of shareholders and encourage activities that conflict with long term wealth creation. The Australian Shareholders' Association (ASA) does not support statutory restrictions on remuneration levels and believes it is the responsibility of the boards of companies to deal with the problem. Nevertheless, ASA recognises an increasing risk of intervention by the Australian Government if the corporate sector fails to act. Consequently, ASA has prepared this updated policy paper for the guidance of listed companies. This updated policy position represents a hardening of ASA's position to one that is more reflective of the attitudes of retail shareholders towards remuneration issues.

### **The ASA Position**

1. The structure and disclosure of executive remuneration should be concise, easily understood and transparent to investors.
2. The base salaries of senior executives need to be and in the great majority of listed companies probably already are, at sufficient levels to provide full and appropriate compensation where performance is adequate but not superior.
3. Incentive payments in addition to base salaries are acceptable where these reward superior, as against merely satisfactory, performance, which has been proven by the achievement of predetermined and challenging targets.
4. It is appropriate for the remuneration package of a CEO to include a substantial "at risk" element. As a broad indication only, intended as a guideline for any board which

is planning the structures of its CEO's remuneration package, an incentive award equal to the amount of the base salary package is acceptable for a CEO who has achieved significantly superior performance. Payments which are significantly above this level, other than on an exceptional basis, are excessive and are unacceptable to retail shareholders.

5. Long-term incentive (LTI) arrangements based on preset performance hurdles and properly aligned with the interests of shareholders are the appropriate means for providing CEOs, and possibly other senior executives, with motivation and reward for demonstrated superior levels of performance. Recommended guidelines for achieving this alignment are set out below.

6. Short term incentives (STIs) are questionable as incentives for CEOs. They should be used only where the performance targets support and are entirely consistent with the company's long-term goals. STI arrangements may be appropriate for other senior executives, providing these awards are conditional upon achieving pre-set performance targets that are clearly disclosed to shareholders.

7. Boards must not permit executives to enter into arrangements (such as hedging) which reduce the risk elements essential to effective incentive schemes.

8. Termination payments to failed executives which are above statutory entitlements or that include additional amounts in lieu of notice are unacceptable to retail shareholders. Boards should consider this when negotiating departure conditions in employment contracts or subsequently.

9. Golden parachutes are totally unacceptable to shareholders. Other lump sum payments additional to the agreed annual remuneration package, for example, executive retention payments, and compensation for "benefits foregone at previous employers" are also in principle unacceptable to shareholders. Any exceptions need to be very clearly described and strongly justified as being in the company's best interests in the remuneration report.

10. Where there has been a significant, for example 20%, vote against a Remuneration Report by independent shareholders and the board concerned has failed to take appropriate corrective action, the ASA intends to vote undirected proxies against the re-election of any of the directors at the next AGM of that company.

## **Guidelines**

### *Long-term Incentives*

1. ASA views long term incentives as a means of (i) rewarding executives for creating shareholder value and (ii) providing incentives to create further value. There is no single test that adequately meets the requirements of both objectives. Consequently, LTIs should be based on two components, each subject to achieving company performance above a hurdle threshold, with all details clearly set out for shareholders at the time of adoption:

a. One component should be clearly aligned with shareholders' interests and based on the achievement of total shareholder return (TSR) above the median for an appropriate comparator group. In this case vesting should commence at a modest level (no more than 10%) only when the company achieves a 51st percentile ranking and should increase progressively to reach full vesting no earlier than at the 75th percentile of the group.

b. The second component should provide an incentive to achieve long-term improvement in company performance, typically the achievement of a hurdle that is based on a pre-set and superior level of increase in company earnings. This can be measured by, for example, growth in earnings per share, return on funds employed or another verifiable metric that the board considers best reflects long-term progress across the cycle.

2. LTI awards should be made in equity.
3. LTI performance should be assessed over a fixed period of no less than four consecutive years, with vesting at completion of the full assessment period.
4. The share prices used within the calculation of the TSR, i.e. those at the start and end dates of the vesting period, may be subject to short-term smoothing in order to avoid the unintended effects of price volatility, (for example, averaging over the three month period around the start and ending dates of the vesting period). However in such cases the formula used must be specified within the LTI scheme at the outset.
5. Should TSR be negative over the vesting assessment period there should be no award for that component, irrespective of relative performance against the comparator group.
6. There should be no retesting of performance against LTI hurdles. The need for retesting is eliminated if the vesting period is adequate and short-term smoothing is adopted.
7. In order to promote and support management succession and other strategic long-term objectives, CEOs' equity-based plans should provide that a meaningful portion of any equity awards shall not be made available to the CEO for at least two years after vesting. This restriction should apply irrespective of whether the CEO remains in the position.
8. There should be no company loans associated with LTIs as this decouples any alignment with shareholders' interests that might otherwise have existed and is an inappropriate use of shareholders' funds.

#### *Short-Term Incentives*

1. Around 50% of STI awards should be based on verifiable financial performance metrics at the company level and/or of the area of responsibility of the individual executive.
2. The remainder of any award should be based on quantifiable performance indicators that are set at the start of the period.
3. In the interests of transparency, the performance indicators used to determine STI awards should be disclosed to shareholders. Disclosure may be retrospective if necessary to avoid disclosing commercially sensitive information.
4. Disclosure of STI amounts paid to senior executives should be supported by details of the maximum and minimum amounts available to be earned under the scheme.
5. A proportion of STI awards (ASA recommends at least 50%) should be in the form of equity. This equity must not be made available to the executive for at least two years after the end of the relevant performance period, irrespective of whether the executive remains in the position.

## 6.5 Surveys and other initiatives

The biannual *Non-executive directors' survey report* (ProNed) provides data and analysis on governance issues, including director remuneration. It includes sections surveying chairs and non-executive directors by type of company, turnover and industry.

The periodic study *Board of Directors Study Australia and New Zealand* (Korn/Ferry International and Egan Associates) sets out areas of corporate governance that directors of

listed entities identify as being of concern. The key concerns in 2009 included the challenges of board remuneration committees.<sup>194</sup>

Various consulting bodies promote discussion of aspects of executive remuneration, including the periodic Remuneration Forums sponsored by Guerdon Associates with CGI Glass Lewis involving non-executive directors, management, institutional investors and proxy group/governance advisers. For instance, it was noted at Remuneration Forum 4 (May 2010) that:

there are still significant differences of opinion between directors and institutional investors on the best LTI performance measures.

Consulting bodies also publish information and advice on matters pertaining to executive remuneration. This includes Guerdon Associates *Executive incentive pay and risk management—a checklist for the board remuneration committee* (June 2010) and PricewaterhouseCoopers *Executive remuneration Fourth edition* (2010).

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<sup>194</sup> at 2-7.

## 7 United Kingdom

*This chapter summarises the regulatory approach to executive remuneration arrangements, and reporting, for various UK entities. It also refers to some guidance on executive remuneration arrangements provided by the private sector.*

### 7.1 Overview

The principal elements of the UK regulatory structure for executive remuneration arrangements and reporting are:

- the UK *Companies Act 2006*, which covers the disclosure of the remuneration policies and arrangements for compensating directors of listed companies
- *The UK Corporate Governance Code*, which is administered by the Financial Reporting Council (FSA), and includes principles for designing remuneration arrangements for directors of listed companies
- the *Executives' Remuneration Reports Regulations 2010* (introduced under the UK *Financial Services Act 2010*), which deals with the disclosure of remuneration policies and arrangements for compensating senior executives (which may also include some directors) of banking institutions and building societies
- the UK Financial Services Authority (FSA) *Remuneration Code*, which requires large banks, building societies and broker-dealers in the UK to establish, implement and maintain remuneration policies for their employees which are consistent with, and promote, effective risk management.<sup>195</sup>

The UK Government also announced in May 2010 that it 'will bring forward detailed proposals for robust action to tackle unacceptable bonuses in the financial services sector; in developing these proposals we will ensure they are effective in reducing risk'.<sup>196</sup>

In addition to these regulatory controls, guidance on suitable remuneration arrangements has been put forward by various private sector bodies, including the Association of British Insurers (ABI).

### 7.2 Companies Act 2006

#### 7.2.1 Overview

The directors of a quoted (listed) UK company must prepare and publish a directors' remuneration report for each financial year.<sup>197</sup>

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<sup>195</sup> Background materials from which current approaches in the UK developed include *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Committee) (1992) paras 4.40-4.46, *Corporate Governance* (Hampel Report) (1998) Chapter 4, *Review of the role and effectiveness of non-executive directors* (Higgs Report) (2003) paras 12.20-12.30, *Guidance on Audit Committees (The Smith Guidance)* (2005) para 2.16, *Directors' Remuneration* (Greenbury Report) (1995).

<sup>196</sup> *The Coalition: our programme for government* (May 2010) at 9.

<sup>197</sup> UK *Companies Act 2006* s 420. Failure to comply is an offence: s 420(2), (3).

The report must first be approved by the board, with each director subject to liability where a report does not comply with the requirements, and the director knew of that non-compliance, was reckless as to whether the report complied, or failed to take reasonable steps to secure compliance.<sup>198</sup>

The mandatory content of the report, which applies to any person who is serving as a director or has so served for any period during the relevant year, is set out in the regulations, and is divided into information about remuneration of directors which is not subject to audit and information which is subject to audit.<sup>199</sup>

### 7.2.2 Information not subject to audit

The information that must be disclosed in the directors' remuneration report, and which is not subject to audit,<sup>200</sup> includes:

- details about the composition of the remuneration committee of the board, as well as the name of any person who provided to the committee advice, or services that materially assisted the committee in their consideration of any matter, whether that person was appointed by the committee and the nature of any other services that that person has provided to the company during the relevant financial year<sup>201</sup>
- a statement of the company's policy on directors' remuneration, including:
  - for each director, a detailed summary of any performance conditions to which any entitlement of the director to share options, or under a long term incentive scheme, is subject
  - an explanation as to why any such performance conditions were chosen
  - a summary of the methods to be used in assessing whether any such performance conditions are met and an explanation as to why those methods were chosen
  - a description of, and an explanation for, any significant amendment proposed to be made to the terms and conditions of any entitlement of a director to share options or under a long term incentive scheme
  - if any entitlement of a director to share options, or under a long term incentive scheme, is not subject to performance conditions, an explanation as to why that is the case
  - the policy statement must, in respect of each director's terms and conditions relating to remuneration, explain the relative importance of those elements which are, and those which are not, related to performance

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<sup>198</sup> UK Companies Act 2006 s 422.

<sup>199</sup> UK Companies Act 2006 s 421; Statutory Instrument 2008 No. 410: *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*, Part 4 and Schedule 8.

<sup>200</sup> Schedule 8 Part 2 (being paragraphs 2-6).

<sup>201</sup> Schedule 8 paragraph 2.

- the policy statement must summarise, and explain, the company’s policy on the duration of contracts with directors, and notice periods, and termination payments, under such contracts<sup>202</sup>
- a statement of how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors’ remuneration for the relevant financial year<sup>203</sup>
- a performance graph to represent, for each of the financial years in the relevant period, the total shareholder return (identifying the name of the index selected for the purposes of the graph and the reasons for selecting that index, as well as other using other calculations and assumptions as set out in the regulation)<sup>204</sup>
- in respect of service contracts of directors, the date of the contract, the unexpired term and the details of any notice periods; any provision for compensation payable upon early termination of the contract; and such details of other provisions in the contract as are necessary to enable members of the company to estimate the liability of the company in the event of early termination of the contract.<sup>205</sup>

### 7.2.3 Information subject to audit

The information that must be disclosed in the directors’ remuneration report, and which is subject to audit,<sup>206</sup> includes:

- the amount of each director’s emoluments and compensation in the relevant financial year, including salary and fees, bonuses, expense allowances, any compensation for loss of office, any other payments in connection with the termination of qualifying services and the total estimated value of any benefits received otherwise than in cash. The report must also state the nature of any element of a remuneration package that is not cash<sup>207</sup>
- details of share option arrangements for a director, including:
  - the number of shares that are subject to a share option (with further details)
  - information identifying those share options that have been awarded in the relevant financial year, those that have been exercised in that year, those that in that year have expired unexercised and those whose terms and conditions have been varied in that year
  - for each unexpired option, the price paid for its award, the exercise price, the date from which the option may be exercised, the date on which the option expires
  - a summary of any performance criteria upon which the award or exercise of a share option is conditional

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<sup>202</sup> Schedule 8 paragraph 3.

<sup>203</sup> Schedule 8 paragraph 4.

<sup>204</sup> Schedule 8 paragraph 5.

<sup>205</sup> Schedule 8 paragraph 6.

<sup>206</sup> Schedule 8 Part 3 (being paragraphs 7-16).

<sup>207</sup> Schedule 8 paragraph 7.

- for each share option that has been exercised during the relevant financial year, the market price of the shares, in relation to which it is exercised, at the time of exercise
  - for each share option that is unexpired at the end of the relevant financial year, the market price at the end of that year, and the highest and lowest market prices during that year, of each share that is subject to the option
  - modified information if, in the opinion of the directors of the company, disclosure in accordance with the full requirements would result in a disclosure of excessive length<sup>208</sup>
- information about long term incentive schemes for directors, including:
    - in regard to scheme interests awarded to a director during the relevant financial year and where shares may become receivable in respect of the interest, the number of those shares, the market price of each of those shares when the scheme interest was awarded and details of qualifying conditions that are conditions with respect to performance
    - for each scheme interest that has vested in the relevant financial year, relevant details, including the number of those shares, the date on which the scheme interest was awarded, the market price of each of those shares when the scheme interest was awarded, the market price of each of those shares when the scheme interest vested, and details of qualifying conditions that were conditions with respect to performance<sup>209</sup>
  - details of pension arrangements, including in regard to any defined benefit scheme or money purchase scheme for a director<sup>210</sup>
  - information on any excess retirement benefits of directors and past directors<sup>211</sup>
  - compensation for past directors<sup>212</sup>
  - any sums paid to third parties in respect of a director's services.<sup>213</sup>

### 7.3 The UK Corporate Governance Code

The UK Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting confidence in corporate governance and reporting, published the most recent version of *The UK Corporate Governance Code* (formerly called the UK Combined Code on Corporate Governance) in June 2010.

The Code consists of principles (main and supporting), which set the context in which directors and boards are to operate, and provisions to implement the principles. The Code is implemented through listing rule reporting requirements, under a 'comply or explain' approach.

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<sup>208</sup> Schedule 8 paragraphs 8-10.

<sup>209</sup> Schedule 8 paragraphs 11-12.

<sup>210</sup> Schedule 8 paragraph 13.

<sup>211</sup> Schedule 8 paragraph 14.

<sup>212</sup> Schedule 8 paragraph 15.

<sup>213</sup> Schedule 8 paragraph 16.



The principles and provisions dealing with executive remuneration, set out in Section D and Schedule A of the Code, are as follows.

## **Section D: Remuneration**

### **D.1 The Level and Components of Remuneration**

#### *Main Principle*

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

#### *Supporting Principle*

The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

#### *Code Provisions*

D.1.1 In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code.

D.1.2 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report<sup>214</sup> should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

D.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. If, exceptionally, 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 non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision B.1.1).

D.1.4 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

D.1.5 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

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<sup>214</sup> As required for UK incorporated companies under the *Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008*.

## D.2 Procedure

### *Main Principle*

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

### *Supporting Principles*

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration.

### *Code Provisions*

D.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company.

D.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

D.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

D.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

### **Schedule A: The design of performance-related remuneration for executive directors**

The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.

The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.

In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.

Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or, at least, form part of a well considered overall plan incorporating existing schemes. The total potentially available rewards should not be excessive.

Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives, including non-financial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems.

Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.

Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.

In general, only basic salary should be pensionable. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

#### 7.4 Executive remuneration reports for banking institutions

Consistent with recommendations in the report by Sir David Walker *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (November 2009), directors of large UK banking institutions and building societies ('relevant banking institutions'<sup>215</sup>) must prepare and publish annually a report containing disclosures about the remuneration of their 'relevant executives'. These requirements are set out in *Executives' Remuneration Reports Regulations 2010*, introduced under the UK *Financial Services Act 2010*.

A 'relevant executive' is anyone who is employed by a relevant banking institution with an aggregate annual remuneration paid or receivable (directly or indirectly) in excess of £500,000.<sup>216</sup>

The report must first be approved by the board, with each director subject to liability where a report does not comply with the requirements, and the director knew of that non-compliance, was reckless as to whether the report complied, or failed to take reasonable steps to secure compliance. A parent entity in a group that contains two or more banking institutions must also prepare an executives' remuneration report for the group.<sup>217</sup>

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<sup>215</sup> Regulation 3 defines 'relevant banking institution'.

<sup>216</sup> Regulation 4.

<sup>217</sup> Regulations 5-8.

The report must be provided to members and others and a copy posted on the entity's website.<sup>218</sup> The report must be tabled at the annual general meeting and put to the vote of the meeting.<sup>219</sup> The report must also be filed with the relevant regulator.<sup>220</sup>

The executives' remuneration report must disclose various matters (unless already disclosed in the directors' remuneration report, or in the notes to the accounts, as required under the UK *Companies Act 2006*):

*Statement of policy on executives' remuneration*

- a statement of the remuneration policy for relevant executives for the current year and subsequent financial years
- that policy statement must include a summary of any performance conditions attached to any share options, long-term incentive scheme awards or bonuses granted to relevant executives, with an explanation of why any such performance conditions were chosen, and, if there are no performance conditions attached to a particular entitlement, an explanation of why not
- an explanation of how the remuneration policy takes account of the risks to which the entity is exposed<sup>221</sup>

*Remuneration committee report*

- a report from the remuneration committee setting out the decision-making process used to determine the remuneration policy for relevant executives; stating whether it considers the performance conditions adopted for relevant executives to be appropriate, and stating whether it considers the remuneration policy and practices to be compatible with effective risk management<sup>222</sup>

*Total amount of executive remuneration*

- the number of relevant executives, being persons whose remuneration in the preceding financial year exceeded £500,000, disclosed in bands of £500,000 up to £5million and thereafter in £1million bands<sup>223</sup>

*Categories of remuneration*

- information on the aggregate amounts earned by relevant executives in each of these bands according to:
  - base salary
  - fees
  - expense allowances
  - bonuses
  - benefits receivable under long-term incentive schemes
  - share options
  - pension scheme contributions by the firm.<sup>224</sup>

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<sup>218</sup> Regulations 9-12.

<sup>219</sup> Regulations 13-14.

<sup>220</sup> Regulations 15-16.

<sup>221</sup> See further paragraph 2 of the Schedule *Executives' remuneration report: content* in the *Executives' Remuneration Reports Regulations 2010*.

<sup>222</sup> Paragraph 3 of the Schedule.

<sup>223</sup> Paragraph 4 of the Schedule.

## 7.5 FSA Remuneration Code

The UK Financial Services Authority (FSA) *Remuneration Code*,<sup>225</sup> which came into effect in January 2010, requires large banks, building societies and broker-dealers in the United Kingdom to establish, implement and maintain remuneration policies for their employees that are consistent with and promote effective risk management and do not expose the entities to excessive risk. The Code is designed to be consistent with the recommendations of the Financial Stability Board (see Section 10.2) and with European Union measures concerning financial institutions (see Section 8.1.2).

The Code seeks to achieve two overriding objectives:

- that boards focus more closely on ensuring that the total amount distributed by a firm to its employees is consistent with good risk management and sustainability
- that individual compensation practices for employees provide the right incentives.

The general requirement of the Code is that:

Remuneration policies must be consistent with effective risk management.<sup>226</sup>

In this context, the Code points out that:

If a firm's remuneration policy is not aligned with effective risk management it is likely that employees will have incentives to act in ways that might undermine effective risk management.<sup>227</sup>

The Remuneration Code covers all aspects of remuneration for employees that can have a bearing on effective risk management including wages, hiring and ongoing bonuses, long-term incentive plans, options, severance packages and pension arrangements:

The principles in the Remuneration Code will be used by the FSA to assess the quality of a firm's remuneration policies and whether they encourage excessive risk-taking by a firm's employees.<sup>228</sup>

The Code is concerned with the risks created by the way that remuneration arrangements are structured, not with the absolute amounts of remuneration, which remain a matter for the remuneration committees and boards of firms.<sup>229</sup>

The Remuneration Code contains various observations, suggestions and directions, grouped round eight remuneration principles or themes.<sup>230</sup> They include the following comments:

*Principle 1 Role of bodies responsible for remuneration policies and their members*

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<sup>224</sup> Paragraph 5 of the Schedule. Long-term incentiveschemes are defined in paragraph 9 of the Schedule, while pension schemes are defined in paragraph 10 of the Schedule.

<sup>225</sup> See FSA Handbook: Senior Management Arrangements, Systems and Controls sourcebook (SYSC) Section 19 *Remuneration Code*.

<sup>226</sup> Section 19.2.

<sup>227</sup> Section 19.2.2(1).

<sup>228</sup> Section 19.2.2(5).

<sup>229</sup> Section 19.2.2(7).

<sup>230</sup> The principles and commentary are set out in Section 19.3.

The risks arising from the way employees are recruited and managed, including the risks posed by remuneration policies constitute some of the most important risks faced by firms. Remuneration committees should pay specific attention to these risks.<sup>231</sup>

While industry comparators may be relevant in setting remuneration they should not override the need for independent decisions that are consistent with the firm's financial situation and prospects.<sup>232</sup>

*Principle 2: Procedures and risk and compliance function input*

The procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.<sup>233</sup>

Documenting procedures for setting remuneration includes documenting all performance appraisal processes and decisions.<sup>234</sup>

*Principle 3: Remuneration of employees in risk and compliance functions*

Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.<sup>235</sup>

Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions.<sup>236</sup>

The FSA would generally expect the ratio of the potential variable to fixed component of remuneration to be significantly lower for employees in risk management and compliance functions than for employees in other business areas whose potential bonus is a significant proportion of their remuneration.<sup>237</sup>

*Principle 4: Profit-based measurement and risk-adjustment*

Assessments of financial performance used to calculate bonus pools should be based principally on profits.<sup>238</sup>

A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.<sup>239</sup>

Measuring performance based wholly or mainly on revenues or turnover can provide an incentive for employees to pay insufficient regard to the quality of business undertaken or services provided, or their appropriateness for the client.<sup>240</sup>

Profits are a better measure, but they should be adjusted for risk, including future risks not adequately captured by accounting profits.<sup>241</sup>

A number of techniques are available to adjust profits and capital for risk, and a firm should choose those most appropriate to its circumstances. Common techniques include those based upon a calculation of economic profit or economic capital. Whichever technique is chosen, the full range of potential risks should be covered.

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<sup>231</sup> Section 19.3.2(1).  
<sup>232</sup> Section 19.3.2(2).  
<sup>233</sup> Section 19.3.3(1).  
<sup>234</sup> Section 19.3.4(3).  
<sup>235</sup> Section 19.3.5(1).  
<sup>236</sup> Section 19.3.5(2).  
<sup>237</sup> Section 19.3.6(3).  
<sup>238</sup> Section 19.3.7(1).  
<sup>239</sup> Section 19.3.7(2).  
<sup>240</sup> Section 19.3.8(1).  
<sup>241</sup> Section 19.3.8(2).

The FSA expects a firm to be able to provide it with information relating to the workings of the calculations. The results of risk-adjustment are not foolproof, and accordingly a firm should apply judgment and common sense in the final decision about the performance-related component of remuneration.<sup>242</sup>

*Principle 5: Long-term performance measurement*

Where the performance-related component of an employee's remuneration is a significant part of his total remuneration, the assessment process should be designed to ensure assessment is based on longer-term performance.<sup>243</sup>

Profits from a firm's activities can be volatile and subject to cycles. The financial performance of firms and individual employees can be exaggerated as a result and so the performance-related component of remuneration should not be assessed solely on the results of the current financial year. Effective adjustment for current and future risks in line with Remuneration Principle 4 may also be relevant to compliance with Remuneration Principle 5.<sup>244</sup>

Performance assessment on a moving average of results can be a good way of meeting Remuneration Principle 5. However, other techniques such as good quality risk adjustment and deferment of a sufficiently large proportion of remuneration may also be useful (see Remuneration Principles 4 and 8).<sup>245</sup>

In considering whether the performance-related component of an employee's remuneration is a significant part of his total remuneration, relevant factors include (a) the proportion of total remuneration which is performance-related and (b) the absolute amount of remuneration which is performance-related. So, for example, it may be consistent with effective risk management to pay a proportionately higher performance-related bonus to a relatively low-paid employee without basing the bonus on longer-term performance.<sup>246</sup>

*Principle 6: Non-financial performance metrics*

Non-financial performance metrics should form a significant part of the performance assessment process.<sup>247</sup>

Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements.<sup>248</sup>

Poor performance in non-financial metrics such as poor risk management or other behaviours contrary to firm values can pose significant risks for a firm and should, as appropriate, override metrics of financial performance.<sup>249</sup>

*Principle 7: Measurement of performance for long-term incentive plans*

The measurement of performance for long-term incentive plans, including those based on the performance of shares, should take account of future risks.<sup>250</sup>

Many common measures of performance for long-term incentive plans, such as earnings per share (EPS), are not adjusted for longer-term risk factors. Total

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<sup>242</sup> Section 19.3.8(5).  
<sup>243</sup> Section 19.3.9(1).  
<sup>244</sup> Section 19.3.10(1).  
<sup>245</sup> Section 19.3.10(2).  
<sup>246</sup> Section 19.3.10(3).  
<sup>247</sup> Section 19.3.11(1).  
<sup>248</sup> Section 19.3.11(2).  
<sup>249</sup> Section 19.3.12(1).  
<sup>250</sup> Section 19.3.13(1).

shareholder return (TSR), another common measure, includes in its measurement dividend distributions, which can also be based on unadjusted earnings data. If incentive plans mature within a two to four year period and are based on EPS or TSR, strategies can be devised to boost EPS or TSR during the life of the plan, to the detriment of the true longer-term health of a firm. For example, increasing leverage is a technique which can be used to boost EPS and TSR. Firms should take account of these factors when developing risk-adjustment methods.<sup>251</sup>

*Principle 8: Remuneration structures*

It is good practice for the fixed component of an employee's remuneration to be a sufficient proportion of their total remuneration to allow a firm to operate a fully flexible bonus policy. This means that a firm (or a part of it) would have the ability not to pay a bonus in a year in which the firm (or part of it) makes a loss. Such a practice need not prevent a firm from paying a bonus despite making a loss if the bonus is justified on other grounds, for example incentivising employees involved in new business ventures which could be loss-making in their early stages.<sup>252</sup>

It is good practice for a significant proportion of any bonus to be deferred with a minimum vesting period. Both the proportion of the bonus to be deferred and the vesting period should be appropriate to the nature of the business and its risks. The vesting period of the deferred element should be at least three years. In relation to the proportion to be deferred, if the bonus is significant when compared with the fixed component of an employee's remuneration, a reasonable starting point would be to defer at least two-thirds of the bonus.<sup>253</sup>

It is good practice for a significant proportion of the variable component of remuneration to be linked to the future performance of (a) the firm and where practicable the employee's division or business unit or (b) the business undertaken by the employee.<sup>254</sup>

Deferred compensation paid in shares can meet Remuneration Principle 8 provided that the scheme satisfies appropriate criteria, including risk-adjustment of the performance measure used to determine the initial allocation of shares.<sup>255</sup>

Deferred remuneration paid in cash should also be subject to performance criteria.<sup>256</sup>

Bonus pools and individual bonuses should be based on employee, division, business unit, or firm performance during the period under review. Both linkage to the future performance of the firm and linkage to the future performance of a division or business unit can deliver important benefits. The former promotes teamwork, while the latter assures that the risks which the employee had a role in assuming continue to have a bearing on his remuneration. It is good practice for remuneration awards to be based on an appropriate combination of all of these factors.<sup>257</sup>

'Guaranteed minimum bonuses' which run for a period of more than one year and similar payments in addition to an employee's salary that are not based on performance during the performance period under review are likely to be inconsistent with Remuneration Principle 8.<sup>258</sup>

<sup>251</sup> Section 19.3.14.

<sup>252</sup> Section 19.3.17(1).

<sup>253</sup> Section 19.3.17(2).

<sup>254</sup> Section 19.3.17(3).

<sup>255</sup> Section 19.3.17(4).

<sup>256</sup> Section 19.3.17(5).

<sup>257</sup> Section 19.3.17(6).

<sup>258</sup> Section 19.3.17(7).



## 7.6 Private sector initiatives

As in Australia, professional and industry bodies have put forward guidelines on executive remuneration.

Included among them is the Association of British Insurers (ABI), which published revised guidelines in December 2009 on policies and practices for executive remuneration, comprising principles, main provisions and more detailed guidance. These guidelines are predominantly for companies with a UK main market listing but are also put forward by the ABI as useful for companies on other public markets and for other entities. The ABI encourages all companies to observe the guidelines in the spirit of best practice.<sup>259</sup>

Set out below are the principles and main provisions of the ABI guidelines.

### Principles

Boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy, taking risks fully into account, and reviewed regularly.

Remuneration Committees should be established in accordance with the provisions of the [UK Corporate Governance Council]. They should comprise independent directors who bring thought and scrutiny to all aspects of remuneration. It is important to maintain a constructive and timely dialogue between boards and shareholders regarding remuneration policies and practices.

Executive remuneration should be set at levels that retain and motivate, based on selection and interpretation of appropriate benchmarks which should be used with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

Executive remuneration should be linked to individual and corporate performance through graduated targets, that align the interests of executives with those of shareholders. The resulting arrangements should be clear and readily understandable

Shareholders will not support arrangements which entitle executives to reward when this is not justified by performance. Remuneration Committees should ensure that service contracts contain provisions that are consistent with this principle.

### Section I—Remuneration committees and their responsibilities

#### Main provisions

Remuneration Committees are responsible for ensuring that the mix of incentives reflects the company's needs, establishes an appropriate balance between fixed and variable remuneration, and is based on targets that are appropriately stretching, verifiable and relevant and which take account of risk. They should satisfy themselves as to the accuracy of recorded performance measures that govern vesting of variable and share-based remuneration.

They should establish effective procedures for disclosure and communication of strategic objectives, which enable shareholders to take an informed and considered

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<sup>259</sup> The complete guidelines, including the guidance on matters set out in Sections II and III of the guidelines, and the accompanying ABI Position paper *Executive remuneration* (December 2009), which is directed to remuneration committees of company boards, are available under **Guidelines** (1. Executive compensation and share based remuneration) on [www.ivis.co.uk](http://www.ivis.co.uk)

view of remuneration policy and its implementation. Where appropriate, account should be taken of the ABI Guidelines on Responsible Investment Disclosure.

They should ensure that remuneration levels properly reflect the contribution of executives and be rigorous in selecting an appropriate comparator group. They should guard against unjustified windfalls and inappropriate gains arising from the operation of share incentive schemes and other associated incentives.

Where performance achievements are subsequently found to have been significantly mis-stated so that bonuses and other incentives should not have been paid, effective avenues of redress should be considered.

Remuneration Committees should also pay particular attention to arrangements for senior executives who are not board members but have a significant influence over the company's ability to meet its strategic objectives. In this context, they should have oversight of all associated risks arising throughout the firm as a result of remuneration. Boards should consider disclosure of these risks and how they are managed in accordance with their obligations under the Enhanced Business Review.

## **Section II—Guidance for base pay, bonuses, pensions and contracts and severance**

### **1. Base and pay bonuses**

#### Main provisions

Remuneration Committees should ensure that base pay reflects the contribution of the executives concerned and be robust in setting and monitoring targets for bonuses. They should ensure that bonuses reflect actual achievements against these targets.

Any material payments that may be viewed as being ex-gratia in nature should be fully explained, justified and subject to shareholder approval prior to payment. Shareholders are not supportive of transaction bonuses that reward directors and other executives for effecting transactions irrespective of their future financial consequences.

Remuneration Committees should scrutinise all other benefits, including benefits in kind and other financial arrangements to ensure they are justified, appropriately valued and suitably disclosed.

### **2. Pensions**

#### Main provisions

Remuneration Committees should recognise the impact that pension arrangements can have on the mix between fixed and variable pay. In setting an appropriate balance, they should bear in mind that pension entitlements may represent a significant and potentially costly item of remuneration that is not directly linked to performance.

### **3. Contracts and severance**

#### Main provisions

Remuneration Committees should ensure that contracts protect the company from being exposed to the risk of payment in the event of failure.

The treatment of bonuses should be clear and a contractual link established between variable pay and performance. In the event of early termination there should be no automatic entitlement to bonuses or share-based payments.

### Section III—Guidance for share-based incentive schemes

#### Main provisions

Share-based incentives should align the interests of executive directors with that of shareholders and link reward to performance over the longer term. Vesting should therefore be based on performance conditions measured over a period appropriate to the strategic objectives of the company. This will not be less than, and may exceed, three years.

All new share-based incentives or any substantive changes to existing schemes should be subject to prior approval by shareholders by means of a separate and binding resolution. Their operation, rationale and cost should be fully explained so that shareholders can make an informed judgment.

The operation of share incentive schemes should not lead to dilution in excess of the limits acceptable to shareholders.

Executive share options should not be granted at a discount to the prevailing market price.

It is desirable to align the interests of chairmen and independent directors with those of shareholders, for example through payment in shares bought at market prices. However, shareholders consider it inappropriate for chairmen and independent directors to receive incentive awards geared to the share price or corporate performance that would impair their ability to provide impartial oversight and advice.

Shareholders encourage companies to require executive directors and senior executives to build up meaningful shareholdings in the companies for which they work.

**Guidance** The guidance applies to all share-based schemes whether option-based or involving conditional awards of shares, and including any arrangements whereby the value of an option gain will be paid either in the form of cash or shares (cash or share-settled share appreciation rights respectively).



## 8 European Union

*This chapter sets out a series of initiatives developed in the European Union in relation to the content of remuneration arrangements and how they might be disclosed.*

### 8.1 European Commission

#### 8.1.1 Listed companies

In response to what the European Commission (EC) described as concerns about the substantial increase in the variable component of the remuneration of directors of European Union (EU) listed companies, and questions about the methods and content of performance evaluations for those directors, the EC, in 2004, adopted a recommendation (2004/913/EC, added to by 2005/162/EC) aimed at strengthening obligations of these companies to publish director remuneration policies and individual salaries. That recommendation also called on the Member States of the EU to establish a shareholder vote (mandatory or optional) on director remuneration.

For various reasons referred to by the EC, including the lack of shareholder activism, the ‘explosion’ of the variable component of remuneration arrangements, and the multiplication of profit-sharing plans granting shares or stock options, the EC considered it necessary to adopt a new *Recommendation 2009/385/EC* in April 2009, dealing with the remuneration of directors of listed companies.

The aim of the Recommendation is to strengthen the governance of directors’ remuneration, including through the introduction of various principles for director remuneration arrangements that are intended better to link remuneration to long-term performance.

*Recommendation 2009/385/EC* contains various general statements concerning the remuneration of directors, including:

(3) Whilst the form, structure and level of directors’ remuneration continue to be matters primarily falling within the competence of companies, their shareholders and, where applicable, employee representatives, the Commission considers that there is a need for additional principles regarding the structure of directors’ remuneration, as set out in a company’s remuneration policy and the process of determining remuneration and control on that process.

(6) The structure of directors’ remuneration should promote the long-term sustainability of the company and ensure that remuneration is based on performance. Variable components of remuneration should therefore be linked to predetermined and measurable performance criteria, including criteria of a non-financial nature. Limits should be set on the variable components of remuneration. Significant variable components of remuneration should be deferred for a certain period, for example, three to five years, subject to performance conditions. Further, companies should be able to reclaim variable components of remuneration that were paid on the basis of data, which proved to be manifestly misstated.

(7) It is necessary to ensure that termination payments, so-called "golden parachutes", are not a reward for failure and that the primary purpose of termination payments as a safety net in case of early termination of the contract is respected. To that purpose, termination payments should be limited to a certain amount or duration beforehand, which, in general, should not be more than two years’ annual remuneration (on the

basis of only the non-variable component of the annual remuneration) and not be paid if the termination is due to inadequate performance or if a director leaves on his own account. This does not preclude termination payments in situations of early termination of the contract, due to changes in the strategy of the company or in merger and/or takeover situations.

(8) Schemes under which directors are remunerated in shares, share options or any other right to acquire shares or be remunerated on the basis of share price movements should be better linked to performance and long-term value creation of the company. Therefore, an appropriate vesting period should apply to shares, whereby vesting is made subject to performance conditions. Share options and rights to acquire shares or be remunerated on the basis of share price movements should be not be exercisable during an appropriate period and the right to exercise them should be made subject to performance conditions. In order to further prevent conflicts of interest of directors who hold shares in the company, these directors should be obliged to retain a part of their shares until the end of their mandate.

(9) In order to facilitate the shareholders' assessment of the company's approach to remuneration and strengthen the company's accountability towards its shareholders, the remuneration statement should be clear and easily understandable. Moreover, further disclosure of information relating to the structure of remuneration is necessary.

The principles to implement the general statements, as set out in the Recommendation, include the following:

#### *Remuneration policy*

3.1. Where the remuneration policy includes variable components of remuneration, companies should set limits on the variable component(s). The non-variable component of remuneration should be sufficient to allow the company to withhold variable components of remuneration when performance criteria are not met.

3.2. Award of variable components of remuneration should be subject to predetermined and measurable performance criteria. Performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long-term value creation, such as compliance with applicable rules and procedures.

3.3. Where a variable component of remuneration is awarded, a major part of the variable component should be deferred for a minimum period of time. The part of the variable component subject to deferment should be determined in relation to the relative weight of the variable component compared to the non-variable component of remuneration.

3.4. Contractual arrangements with executive or managing directors should include provisions that permit the company to reclaim variable components of remuneration that were awarded on the basis of data which subsequently proved to be manifestly misstated.

3.5. Termination payments should not exceed a fixed amount or fixed number of years of annual remuneration, which should, in general, not be higher than two years of the non-variable component of remuneration or the equivalent thereof. Termination payments should not be paid if the termination is due to inadequate performance.

#### *4. Share-based remuneration*

4.1. Shares should not vest for at least three years after their award. Share options or any other right to acquire shares or to be remunerated on the basis of share price movements should not be exercisable for at least three years after their award.

4.2. Vesting of shares and the right to exercise share options or any other right to acquire shares or to be remunerated on the basis of share price movements, should be subject to predetermined and measurable performance criteria.

4.3. After vesting, directors should retain a number of shares, until the end of their mandate, subject to the need to finance any costs related to acquisition of the shares. The number of shares to be retained should be fixed, for example, twice the value of total annual remuneration (the non-variable plus the variable components).

4.4. Remuneration of non-executive or supervisory directors should not include share options.

*5. Disclosure of the policy on directors' remuneration*

5.1. The remuneration statement, mentioned in point 3.1 should be clear and easily understandable.

5.2. In addition to the information set out in point 3.3 of Recommendation 2004/913/EC, the remuneration statement should include the following:

(a) an explanation how the choice of performance criteria contributes to the long-term interests of the company, in accordance with point 3.2 of this Recommendation

(b) an explanation of the methods, applied in order to determine whether performance criteria have been fulfilled

(c) sufficient information on deferment periods with regard to variable components of remuneration, as referred to in point 3.3 of this Recommendation

(d) sufficient information on the policy regarding termination payments, as referred to in point 3.4 of this Recommendation

(e) sufficient information with regard to vesting periods for share-based remuneration, as referred to in point 4.1 of this Recommendation

(f) sufficient information on the policy regarding retention of shares after vesting, as referred to in point 4.3 of this Recommendation

(g) sufficient information on the composition of peer groups of companies the remuneration policy of which has been examined in relation to the establishment of the remuneration policy of the company concerned.

The EC Green Paper *Corporate governance in financial institutions and remuneration policies* (June 2010), in noting the uneven level of implementation of *Recommendation 2009/385/EC* amongst EU Member States in the year since its introduction, observed that:

The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least. The growing importance of financial markets in the economy, due in particular to the multiplication of sources of financing/capital injections, has created new categories of shareholders. Such shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons. In this respect, the sought-after alignment of directors' interests with those of these new categories of shareholder has amplified risk-taking and, in many cases,

contributed to excessive remuneration for directors, based on the short-term share value of the company/financial institution as the only performance criterion.<sup>260</sup>

The Green Paper also initiated a discussion (with requests for submissions by September 2010) on possible future regulatory directions, including the following questions for consideration:

What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?<sup>261</sup>

Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?<sup>262</sup>

### 8.1.2 Financial institutions

The EC has commented that remuneration policies in the financial sector, based on short-term profits and taking no account of the corresponding risks, contributed to the international financial crisis. For this reason, the Commission adopted *Recommendation 2009/384/EC* (April 2009) which deals with remuneration policies in the financial sector. The aim of the Recommendation is to align remuneration policies in the financial services with healthy risk management and the long-term viability of financial institutions.

*Recommendation 2009/384/EC* contains various general statements concerning remuneration policies in the financial services sector, including:

(4) In principle, if risk management and control systems were strong and highly effective, the risk-taking incentives provided by remuneration practices would be consistent with the risk tolerance of a financial undertaking. However, all risk management and control systems have limitations and, as the financial crisis has shown, can fail to deal with the risks created by inappropriate incentives, due to the increasing complexity of the risks and the range of ways by which risk may be taken. Consequently, a simple functional separation between business units and staff responsible for risk management and control systems is necessary but no longer sufficient.

(5) Creating appropriate incentives within the remuneration system itself should reduce the burden on risk management and increase the likelihood that these systems become effective. Therefore, there is a need to establish principles on sound remuneration policies.

(11) The remuneration policy of a particular financial undertaking should also be linked to the size of the financial undertaking concerned, as well as the nature and the complexity of its activities.

(13) Remuneration policy should cover those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking. In order to avoid incentives for excessive risk-taking, special arrangements should be adopted with regard to the remuneration of these categories of staff.

(14) Remuneration policy should aim at aligning the personal objectives of staff members with the long-term interests of the financial undertaking concerned. The assessment of the performance-based components of remuneration should be based on

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<sup>260</sup> at 8.

<sup>261</sup> Specific question 7.1.

<sup>262</sup> Specific question 7.2.



longer-term performance and take into account the outstanding risks associated with the performance. The assessment of performance should be set in a multi-year framework, for example of three to five years, in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over the business cycle of the company.

(15) Financial undertakings should be able to reclaim variable components of remuneration that were awarded for performance based on data which has subsequently proven to be manifestly misstated.

(16) As a general principle, payments related to early termination of a contract which are awarded on a contractual basis should not be a reward for failure. For directors of listed financial undertakings, specific provisions on termination payments set out in Recommendation 2009/385/EC should apply.

(17) In order for remuneration policy to be in line with the objectives, the business strategy, the values and the long-term interests of the financial institution, other factors, apart from financial performance, should be considered, such as compliance with systems and controls of the financial institution, as well as compliance with the standards governing the relationship with clients and investors.

(18) Effective governance is a necessary condition for the remuneration policy to be sound. The decision-making process regarding the remuneration policy of a financial undertaking should be internally transparent and should be designed in such a way as to avoid conflicts of interest and ensure the independence of the persons involved.

The principles to implement the general statements, as set out in the Recommendation, include the following:

#### *4. Structure of the remuneration policy*

4.1. Where remuneration includes a variable component or a bonus, remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components. The appropriate balance of remuneration components may vary across staff members, according to market conditions and the specific context in which the financial undertaking operates. Member States should ensure that remuneration policy of a financial undertaking sets a maximum limit on the variable component.

4.2. The fixed component of the remuneration should represent a sufficiently high proportion of the total remuneration allowing the financial undertaking to operate a fully flexible bonus policy. In particular, the financial undertaking should be able to withhold bonuses entirely or partly when performance criteria are not met by the individual concerned, the business unit concerned or the financial undertaking. The financial undertaking should also be able to withhold bonuses where its situation deteriorates significantly, in particular where it can no longer be presumed that it can or will continue to be able to carry out its business as a going concern.

4.3. Where a significant bonus is awarded, the major part of the bonus should be deferred with a minimum deferment period. The amount of the deferred part of the bonus should be determined in relation to the total amount of the bonus as compared to the total amount of the remuneration.

4.4. The deferred element of the bonus should take into account the outstanding risks associated with the performance to which the bonus relates and may consist of equity, options, cash, or other funds the payment of which is postponed for the duration of the deferment period. The measures of future performance to which the deferred element is linked should be risk adjusted as set out in point 5.

4.5. Payments related to the early termination of a contract which are awarded on a contractual basis, should be related to performance achieved over time and designed in a way that does not reward failure.

4.7. The structure of the remuneration policy should be updated over time to ensure that it evolves to meet the changing situation of the financial undertaking concerned.

#### 5. *Performance measurement*

5.1. Where remuneration is performance related, its total amount should be based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the financial undertaking.

5.2. The assessment of performance should be set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of bonuses is spread over the business cycle of the company.

5.3. The measurement of performance, as a basis for bonus or bonus pools, should include an adjustment for current and future risks related to the underlying performance and should take into account the cost of the capital employed and the liquidity required.

5.4. When determining individual performance, non-financial criteria, such as compliance with internal rules and procedures, as well as compliance with the standards governing the relationship with clients and investors should be taken into account.

#### Disclosure

7. Without prejudice to confidentiality and data protection provisions, relevant information on the remuneration policy referred to [above] and any updates in case of policy changes should be disclosed by the financial undertaking in a clear and easily understandable way to relevant stakeholders. Such disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements or any other form.

8. The following information should be disclosed:

- (a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the name of the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders
- (b) information on linkage between pay and performance
- (c) information on the criteria used for performance measurement and the risk adjustment
- (d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based
- (e) the main parameters and rationale for any annual bonus scheme and any other non-cash benefits.

9. When determining the level of the information which should be disclosed, Member States should take into account the nature, the size as well as the specific scope of activities of the financial undertakings concerned.

The EC Green Paper *Corporate governance in financial institutions and remuneration policies* (June 2010) noted the uneven level of implementation of *Recommendation 2009/384/EC* amongst EU Member States in the year since its introduction. The Green

Paper also stressed that the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions.

The EC also initiated a discussion in that paper (with requests for submissions by September 2010) on possible future regulatory directions, including whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services.<sup>263</sup>

## 8.2 Committee of European Banking Supervisors

The role of the Committee of European Banking Supervisors (CEBS), comprising representatives from the banking supervisory authorities and central banks of the European Union, is to advise the EU Commission in the field of banking activities, including the convergence of supervisory practices, and the enhancement of supervisory co-operation.

In April 2009 CEBS published *High-level Principles for Remuneration Policies*, addressed both to regulators and to regulated EU banking institutions. These principles were developed in close cooperation with the Financial Stability Board, the Basel Committee on Banking Supervision and the Committee of European Securities Regulators. The Principles are:

1. The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long term interests. It should not encourage excessive risk taking. Remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should be adequately rewarded to attract skilled individuals.
2. The remuneration policy should be transparent internally and adequately disclosed externally.
3. The management body, in its supervisory function, should determine the remuneration of the management body in its management function. In addition, the management body, in its supervisory function, should approve the principles of the overall remuneration policy of the institution and maintain oversight of their application. The implementation of the remuneration policy should be subject to central and independent review.
4. Where the pay award is performance related, remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include adjustments for risks and the cost of capital.
5. There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure up-front cash payment but contain a flexible, deferred component [for example, company shares, options or other funds held in a trust or similar account]; it should consider the risk horizon of the underlying performance.

A commentary expands on each of these Principles.

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<sup>263</sup> General question 7a.

CEBS published a subsequent *Report on national implementation of CEBS High-level principles for Remuneration Policies* in June 2010. In releasing the report, CEBS noted:

Both supervisors and institutions have made considerable progress in the field of remuneration; their efforts for change are continuous and genuine, with most countries adopting a regulatory approach for remuneration, supported by supervisory guidance. The most concrete changes observed in institutions are related to the governance mechanisms that must support the remuneration policies and practices. Deferral schemes for variable remuneration are also becoming more frequent.

However, it was noted that the implementation was less satisfactory as regards the adjustment of compensation systems for all material risks. Discrepancies may still be observed between requirements set by supervisors to support adoption of CEBS's principles and remuneration policies and practices that can be observed within supervised institutions. When most pronounced, these discrepancies are caused either by underdeveloped practices in new fields such as risk-adjusted performance measurement, or by remaining uncertainty regarding dimensions such as scope, proportionality and home/host relationships and what implications these can have on the practices of institutions.

CEBS will use the findings of this report as a contribution to the ongoing implementation of its remuneration principles and for preparing guidelines on remuneration policy and practices as required by CRD 3 [EU Directive concerning the supervisory review of remuneration policies].<sup>264</sup>

### 8.3 European Parliament

In July 2010, the European Parliament approved rules to place controls on bonuses paid by European banks, and also passed a non-legislative resolution on remuneration arrangements for listed companies in the European Union.

#### **Bank bonuses**

The rules are designed to reduce the role played by bonuses in the banking sector and overcome what was perceived as the incentives they have created for excessive risk-taking.

Under the rules, to take effect from January 2011:

- upfront cash bonuses will be capped at 30% of the total bonus and to 20% for particularly large bonuses. Between 40% and 60% of any bonus must be deferred for at least three years and can be recovered if investments do not perform as expected. Also, at least 50% of the total bonus must be paid as 'contingent capital' (funds to be called upon first in case of bank difficulties) and shares
- bonuses will also have to be capped as a proportion of salary. Each bank will have to establish limits on bonuses related to salaries, on the basis of EU wide guidelines
- exceptional pension payments must be held back in instruments such as contingent capital that link their final value to the overall strength of the bank. This is designed to avoid repeat of situations in which some bankers retired with substantial pensions unaffected by the crisis their bank was facing.

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<sup>264</sup> CEBS Website: News and Communications, 11 June 2010.

Restrictions have also been placed on the overall amounts that can be paid in bonuses by bailed-out banks.

### ***Remuneration arrangements for listed companies***

This non-legislative resolution deals with remuneration of directors of listed companies and remuneration policies in the financial services sector.<sup>265</sup> The resolution was developed having regard to other EU and international initiatives on these matters,<sup>266</sup> and noted that:

numerous initiatives have been launched at the global, European and national levels to address the issue of problematic remuneration practices, and...a globally coordinated approach is essential in order not only to guarantee a level playing field, but also to ensure the global competitiveness of Europe and to promote sustainable and fair competition between market places.

The resolution was designed as a response to concerns that the structure of some compensation arrangements and the lack of effective control mechanisms contributed to excessive risk-taking and encouraged transactions seeking short-term profits to the detriment of sustainable growth.<sup>267</sup>

The resolution deals with:

- effective governance of compensation
- effective alignment of compensation with prudent risk-taking
- having a balanced structure of the remuneration package
- effective supervisory oversight and involvement by stakeholders.

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<sup>265</sup> The resolution, of 7 July 2010, was based on the report of the Parliament's Committee on Economic and Monetary Affairs *Remuneration of directors of listed companies and remuneration policies in the financial services sector* (2010/2009(INI)). The resolution 'instructs its President to forward this resolution to the Council, the Commission and the EU and national regulatory authorities'.

<sup>266</sup> The European Parliament resolution was developed having regard to a range of European and international initiatives on executive remuneration, principally:

- the European Commission initiatives in 2009 concerning listed companies and financial institutions and the subsequent Green paper *Corporate governance in financial institutions and remuneration policies* (June 2010) [see Section 8.1]
- the Committee of European Banking Supervisors' *High-level Principles for Remuneration Policies* (April 2009) and the follow-up *Report on the national implementation of its High-level Principles for Remuneration Policies* (June 2010) [see Section 8.2]
- the OECD paper *Corporate governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles* (February 2010) [see Section 10.1]
- the Financial Stability Board *Principles for Sound Compensation Practices* (April 2009) and the accompanying *Implementation Standards* (September 2009) [see Section 10.2]
- the Basel Committee *Compensation Principles and Standards Assessment Methodology* (January 2010) [see Section 10.3].

<sup>267</sup> The European Parliament resolution contained the following observations.

In the financial sector and in some listed companies, remuneration policies for categories of staff whose professional activity has a material impact on the company's risk profile have been such as to encourage transactions seeking short-term profits, with increasingly risky business models being developed to that end, to the detriment of workers, savers and investors, and sustainable growth in general.

Inappropriate remuneration structures of some financial institutions that incentivise excessive and imprudent risk-taking played a role in the accumulation of risks that led to the current financial, economic and social crisis, and are therefore a major issue of concern for policy-makers and regulators.

Financial institutions must take into account, as part of their corporate social responsibility, the social environment in which the institution operates, as well as the interests of all of parties involved, such as its clients, shareholders and employees, in an integrated manner.

*Effective alignment of compensation with prudent risk-taking*

Under the terms of the resolution dealing with effective alignment of compensation with prudent risk-taking, the European Parliament:

underlines that remuneration should be adjusted for all types of risks, symmetrical with risk outcomes, and sensitive to the time horizon of current and potential risks that have an impact on the overall performance and stability of the firm

points out that directors should not be driven by personal financial interest in their management of listed companies; considers that the personal financial interest of directors linked to variable remuneration is in many cases in conflict with the long-term interest of the company, including the interests of its employees and stakeholders

believes that compensation systems should be proportionate to the size, internal organisation and complexity of financial institutions and should reflect the diversity between different financial sectors such as banking, insurance and fund management

stresses that the operational risk management arrangements of senior management, risk takers and control functions should be reviewed by, and subject to thorough checks by, the supervisor; considers that such procedures should also apply to staff whose total remuneration, including pension provisions, takes them into the same bracket as these categories as staff

considers that the levels of variable remuneration should be based on predetermined and measurable performance criteria, which should promote the long-term sustainability of the company

stresses that performance-related remuneration should link the size of the bonus pool to the overall performance and capital base of the firm, while an employee's individual performance-related remuneration should be based on a combined assessment of the performance of the individual, that of the business unit concerned and the overall results of the institution

considers that the personal financial interest of directors linked to variable remuneration is, in many cases, in conflict with the long-term interests of the company; stresses that policy on the remuneration of directors and other staff who bear responsibility for risky decisions should be consistent with a balanced and properly functioning system of risk management, and that there should be an appropriate ratio between fixed and variable pay; calls urgently for the introduction, across the board, of measures for the reduction, or indeed the withdrawal, of the variable pay of categories of staff whose performance is responsible for a deterioration in their company's results

is of the opinion that not only quantitative measures, but also quality-linked performance criteria and human judgement should be taken into consideration in order to determine the level of variable compensation

considers that guaranteed bonuses should not be part of the compensation plans

is of the opinion, not only for ethical reasons but also in the interests of social justice and economic sustainability, that the difference between the highest and the lowest remuneration in a company should be reasonable

stresses that firms should establish an internal procedure, approved by the supervisor, to address conflicts which may occur between their risk management and operational units

underlines the need to extend these principles to the remuneration of all employees whose professional activities have a material impact on the risk profile of the company they work for, including senior management, risk-takers, control functions

and those staff whose total remuneration, including pension provisions, takes them into the same bracket

stresses that directors' and officers' liability insurance designed to protect companies' directors, officers and senior managers against claims arising from risky or negligent decisions and actions taken whilst managing their business are not in line with sustainable risk management in the field of remuneration.

#### *A balanced structure of the remuneration package*

Under the terms of the resolution dealing with a balanced structure of the remuneration package, the European Parliament:

stresses that there must be an appropriate balance between variable and fixed remuneration

suggests that variable remuneration should be paid only if it is sustainable in the light of the financial situation and capital base of the institution, and justified in the light of the long-term performance of the firm; considers that for financial institutions, the competent supervision authority should have the right to limit the overall amount of variable remuneration in order to strengthen equity capital

underlines that a substantial proportion of the variable remuneration component should be deferred over a sufficient period; the size of the proportion and the length of the deferral period should be established in accordance with the business cycle, the nature of the business, its risks and the activities of the staff member in question; remuneration payable under deferred arrangements should become a vested right no faster than that payable on a pro-rata basis; at least 40% of the variable remuneration component should be deferred; in the case of a variable remuneration component of a particularly high amount, at least 60% of the amount should be deferred and the deferral period should be no less than 5 years

believes that a substantial proportion of variable compensation should be awarded in non-cash instruments such as subordinated debt, contingent capital, shares or share-linked instruments, as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk

considers that remuneration policies should apply to total remuneration, including pensions and salaries, to avoid 'bonus arbitrage'; believes, furthermore, that 'pension bonuses' should be awarded in non-cash instruments such as subordinated debt, contingent capital, shares or share-linked instruments in order to align long-term incentives

suggests setting an upper limit of the equivalent of two years of the fixed component of directors' pay on severance pay ('golden parachutes') in cases of early termination, and banning severance pay in cases of non-performance or voluntary departure.





## 9 North America

*This chapter sets out the executive remuneration disclosure requirements in Canada, as well as disclosure obligations and recent initiatives regarding executive compensation in the United States.*

### 9.1 Canada

#### 9.1.1 Introduction

The executive remuneration disclosure requirements for Canadian public companies are set out in revised Form 51-102F6 *Statement of Executive Compensation (in respect of financial years ending on or after December 31, 2008)* (the Form), which was prepared by the Canadian Securities Administrators (CSA) and commenced on 31 December 2008.

The Form, comprising seven Items, replaces disclosure requirements first introduced in 1994 and reflected in the predecessor Form 51-102F6 (the Old Form). The contents of the Form were settled by the CSA following a period of public consultation in 2008. As explained by the CSA:

The Old Form [was] substantially the same as executive compensation disclosure requirements introduced in 1994. Since 1994, compensation practices have evolved and become increasingly complex. Under the Old Form, investors [were] provided with fragmented compensation information, which [made] it difficult for them to assess the total compensation paid to executive officers. The purpose of the [Form] is to improve the quality of executive compensation disclosure. Improved disclosure will result in better communication of what the board of directors intended to pay or award certain executive officers or directors and will allow users to assess how decisions about executive compensation are made. ... Our intention is to create a document that will present executive remuneration information in a consistent, meaningful way, and that will continue to provide a suitable framework for disclosure as compensation practices change over time.<sup>268</sup>

#### 9.1.2 Items

The Form comprises a series of Items.

##### *Item 1—General Provisions*

The objective of the Form is that all direct and indirect compensation provided to ‘named executive officers’ (NEOs) (being the chief executive officer, the chief financial officer and, apart from them, each of the three most highly compensated executive officers)<sup>269</sup> and directors for, or in connection with, services they have provided to the company or a subsidiary of the company be disclosed on an annual basis.

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<sup>268</sup> CSA Notice Form 51-102F6 *Statement of Executive Compensation (in respect of financial years ending on or after December 31, 2008)* and consequential amendments: September 18, 2008 at 2.

<sup>269</sup> See definition of ‘named executive officer’ or ‘NEO’ in Section 1.2 and also Section 1.3(6): *Determining if an individual is an NEO*. The disclosure obligations apply to anyone who was a NEO or a director for any period during the relevant financial year.

This disclosure is intended to provide insight into executive compensation as a key aspect of the overall stewardship and governance of the company and will help investors understand how decisions about executive compensation are made.<sup>270</sup>

The Form is designed to improve the manner in which all compensation to NEOs and directors is disclosed. It requires that the total compensation for each of these persons be shown in tabular form, with corresponding narrative discussion and explanation. Details on salaries, bonuses, share and option awards, pension benefits, and termination payments must be clearly shown, with an additional column for any other item of compensation not specifically mentioned in the Form.<sup>271</sup>

To provide flexibility, companies may omit any prescribed information in the Form that does not apply to their remuneration arrangements and may also add information, if necessary, to achieve the objective of the Form.<sup>272</sup>

### ***Item 2—Compensation Discussion and Analysis***

Companies must describe and explain all significant elements of compensation awarded to, earned by, paid to, or payable to NEOs for the most recently completed financial year. Information to be disclosed includes:

- the objectives of any compensation program or strategy
- what the compensation program is designed to reward
- each element of compensation
- why the company chooses to pay each element
- how the company determines the amount (and where applicable, the formula) for each element, and
- how each element of compensation and the company's decisions about that element fit into the company's overall compensation objectives and affect decisions about other elements.<sup>273</sup>

Within that context, companies must disclose the performance goals or similar conditions they use to determine remuneration for their NEOs, unless that would 'seriously prejudice' the company's interests. Any company that does not disclose a specific performance goal or similar condition will still be required to disclose the percentage of an NEO's total compensation that relates to that undisclosed information and how difficult it could be for the NEO, or how likely it will be for the company, to achieve the undisclosed performance goal or similar condition.<sup>274</sup>

Most companies must also provide a performance graph that compares their cumulative total shareholder return over the past five years with a broad equity market index.<sup>275</sup>

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<sup>270</sup> Section 1.1.

<sup>271</sup> Section 1.3.

<sup>272</sup> Section 1.3(2).

<sup>273</sup> Section 2.1(1).

<sup>274</sup> Section 2.1(4).

<sup>275</sup> Section 2.2.

Companies must also describe the process used to grant option-based executive remuneration, including the role of the remuneration committee in setting or amending any equity incentive plan.<sup>276</sup>

### ***Item 3—Summary Compensation Table***

The summary compensation table requires the disclosure, for each NEO, of:

- salary
- share-based awards
- option-based awards
- non-equity incentive plan compensation (such as bonuses)
- pension value
- all other compensation
- the total compensation paid to each executive.<sup>277</sup>

The Form contains detailed guidance on the disclosures required under each column, including use of the grant date fair value of executive share and option awards.<sup>278</sup>

The disclosure must also include a narrative discussion that describes and explains any significant factors necessary to understand the information disclosed in the summary compensation table.<sup>279</sup> It also provides guidance on how to deal with an NEO who also receives compensation as a director.<sup>280</sup>

### ***Item 4—Incentive Plan Awards***

Two tables, separate from the summary compensation table, require more detailed disclosure of equity and non-equity incentive plan awards, namely:

- a table disclosing, for each NEO, all outstanding option-based and share-based awards due at year-end, including the number of securities underlying unexercised options, exercise price and expiration dates for options and the value of unexercised in-the-money options, and the number and market (or payout) value of any share awards that have not vested by the end of the most recent financial year-end<sup>281</sup>
- a table disclosing, for each NEO, the value vested during the year in regard to option-based or share-based awards and the value earned during the year on non-equity incentive plan compensation.<sup>282</sup>

A narrative discussion that describes and explains the significant terms of all plan-based awards must also be included.<sup>283</sup>

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<sup>276</sup> Section 2.3.

<sup>277</sup> Section 3.1(1).

<sup>278</sup> Section 3.1(2)-(13).

<sup>279</sup> Section 3.2.

<sup>280</sup> Section 3.4.

<sup>281</sup> Section 4.1.

<sup>282</sup> Section 4.2.

**Item 5—Pension Plan Benefits**

Information concerning retirement plan benefits for each NEO must be disclosed in two tables:

- a defined benefit plans table disclosing each person's years of service, annual benefits payable at year-end and at age 65, and the present value of the benefit obligations<sup>284</sup>
- a defined contribution plans table disclosing each person's accumulated value at the start of the year and at year-end, and any compensatory and non-compensatory amounts.<sup>285</sup>

A narrative discussion that describes and explains any significant factors necessary to understand the information in the two tables must also be included.<sup>286</sup> Information about deferred compensation plans must also be provided.<sup>287</sup>

**Item 6—Termination and Change of Control Benefits**

The company must disclose information concerning triggering circumstances and other matters related to payments and benefits that a NEO would receive under various termination scenarios, including in regard to:

- retirement
- resignation
- termination
- material change in the executive's responsibilities
- a change in the control of the company.<sup>288</sup>

**Item 7—Director Compensation**

The amount of each form of compensation, and the total compensation, for each director must be disclosed in a separate table, along with a narrative discussion which describes and explains any factors necessary to understand the information in the table.<sup>289</sup> The forms of reportable compensation include:

- fees earned
- share or option-based awards
- non-equity incentive plan compensation
- pension values.

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<sup>283</sup> Section 4.3.

<sup>284</sup> Section 5.1.

<sup>285</sup> Section 5.2.

<sup>286</sup> Section 5.3.

<sup>287</sup> Section 5.4.

<sup>288</sup> Sections 6.1-6.3.

<sup>289</sup> Sections 7.1-7.3.

Information about a director who is also a NEO need not be disclosed under Item 7 if the information is already disclosed under an earlier Item of this Form.

## 9.2 United States

### 9.2.1 Disclosure of remuneration

Annual disclosure of executive remuneration arrangements by US public companies (registrant companies) is regulated by the Securities and Exchange Commission (SEC) Item 402—*Executive Compensation* (pursuant to Regulation S-K under the *Securities Exchange Act of 1934*).

In July 2009, the SEC published proposals to enhance compensation and corporate governance disclosure requirements.<sup>290</sup> They included proposed amendments to Item 402 to:

- adopt grant date fair value for reporting share (stock) and option awards.<sup>291</sup> This approach has also been adopted in Canada
- introduce an additional item concerning how compensation practices affect risk.<sup>292</sup>

These changes to Item 402 were introduced in December 2009.

The SEC also proposed amendments to the disclosure requirements regarding compensation consultants, to deal with potential conflicts of interest.<sup>293</sup> These changes to Item 407 *Corporate governance* were introduced in December 2009.<sup>294</sup>

#### ***Item 402(a): General***

Item 402 requires the clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to directors and ‘named executive officers’ (being the principal executive officer, the principal financial officer, and apart from them, the three most highly compensated executive officers<sup>295</sup>) of registrant companies.

#### ***Item 402(b): Compensation Discussion and Analysis***

The purpose of the Compensation Discussion and Analysis is to provide to investors material information that is necessary to an understanding of the registrant’s compensation policies and decisions regarding the named executive officers:

The Compensation Discussion and Analysis should focus on the material principles underlying the registrant’s executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions. The Compensation Discussion and Analysis shall reflect the individual circumstances of

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<sup>290</sup> SEC Release Nos. 33-9052; 34-60289; C-28817; File No. S7-13-09 (July 2009).

<sup>291</sup> id at 13-20.

<sup>292</sup> id at 6-11.

<sup>293</sup> id at 38-42.

<sup>294</sup> Item 407(e). The *Australian Government Response To the Productivity Commission’s Inquiry on Executive Remuneration in Australia* (April 2010) has indicated an intention to legislate on various aspects of remuneration consultants (response to Recommendations 10 and 11 of the PC report).

<sup>295</sup> Item 402(a), paragraph 3. Also included are up to two additional individuals who would have come within the definition but for the fact that they were not serving as an executive officer of the registrant at the end of the relevant financial year.

the registrant and shall avoid boilerplate language and repetition of the more detailed information set forth in the tables and narrative disclosures that follow.<sup>296</sup>

The principles-based narrative discussion must explain all material elements of the compensation of the named executive officers. The discussion must describe:

- the objectives of the registrant's compensation programs
- what the compensation program is designed to reward
- each element of compensation
- why the registrant chooses to pay each element
- how the registrant determines the amount (and, where applicable, the formula) for each element to pay
- how each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements.<sup>297</sup>

Registrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm for the registrant. In that case, however, the registrant must discuss how difficult it will be for the executive or how likely it will be for the registrant to achieve the undisclosed target levels or other factors.

***Item 402(c): Summary compensation table***

Registrant companies must provide information concerning the compensation for each named executive officer of the registrant company, as specified in the Table, including:

- the dollar value of base salary (cash and non-cash) earned
- the dollar value of bonus (cash and non-cash) earned)
- for awards of stock and options, the aggregate grant date fair value for each award
- the dollar value of all earnings for services performed under non-equity incentive plans
- the nonqualified deferred compensation earnings, such as under defined benefit and actuarial pensions
- all other compensation, including any payments related to termination from the company or a change in control of the registrant.

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<sup>296</sup> Instruction 3 to Item 402(b).

<sup>297</sup> Section 1 of Item 402(b).

***Item 402(d): Grants of plan-based awards table***

Registrant companies must provide information concerning each grant of an award to each named executive officer in the last completed fiscal year under any plan, including awards that subsequently have been transferred, as specified in the Table, including:

- the grant date for equity-based awards
- the dollar value of the estimated future payout under non-equity and equity incentive plan awards
- all other stock and option awards
- the per-share exercise or base price of the options granted in the fiscal year
- the grant date fair value of each stock and option award.

***Item 402(e): Narrative disclosure to summary compensation table and grants of plan-based awards table***

Registrant companies must provide a narrative description of any material factors necessary to an understanding of the information disclosed in the tables in Items 402(c) and 402(d). Examples of such factors are set out, including an explanation of the amount of salary and bonus in proportion to total compensation.

***Item 402(f): Outstanding equity awards at fiscal year-end table***

Registrant companies must provide information concerning unexercised equity awards to each named executive officer, as specified in the Table, including:

- on an award-by-award basis, the number of securities underlying unexercised options that are exercisable and unexercisable
- on an award-by-award basis, the total number of shares underlying unexercised options awarded under any equity incentive plan that have not been earned
- for each instrument, the exercise or base price and expiration date
- the total number of shares of stock that have not vested
- the aggregate market value of shares of stock that have not vested.

***Item 402(g): Option exercises and stock vested table***

Registrant companies must provide information concerning exercise of stock options, and each vesting of stock during the last completed fiscal year for each of the named executive officers, on an aggregated basis, as specified in the Table, including:

- the number of securities for which the options were exercised
- the aggregate dollar value realised upon exercise of options, or upon the transfer of an award for value
- the number of shares of stock that have vested
- the aggregate dollar value realised upon vesting of stock, or upon the transfer of an award for value.

***Item 402(h): Pension Benefits***

Registrant companies must provide information concerning each plan that provides for payments or other benefits at, following, or in connection with retirement, for each named executive officer, as specified in the Table, including:

- the name of the plan
- the number of years of service credited to the named executive officer under the plan
- the actuarial present value of the named executive officer's accumulated benefit under the plan
- the dollar amount of any payments and benefits paid to the named executive officer during the registrant's last completed fiscal year.

Registrant companies must also provide a succinct narrative description of any material factors necessary to an understanding of each plan covered by the Table. Examples are provided.

***Item 402(i): Nonqualified defined contribution and other nonqualified deferred compensation plans***

Registrant companies must provide information concerning each defined contribution or other plan that provides for the deferral of compensation (that is not tax-qualified), for each named executive officer, as specified in the Table, including:

- the dollar amount of aggregate executive and registrant contributions, respectively, during the registrant's last fiscal year
- the dollar amount of aggregate interest or other earnings accrued during the registrant's last fiscal year
- the aggregate dollar amount of all withdrawals by and distributions to the executive during the registrant's last fiscal year
- the dollar amount of total balance of the executive's account as of the end of the registrant's last fiscal year.

Registrant companies must also provide a succinct narrative description of any material factors necessary to an understanding of each plan covered by the Table. Examples are provided.

***Item 402(j): Potential payments upon termination or change-in-control***

In regard to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment to a named executive officer at, following, or in connection with his or her termination, or a change in control of the registrant or a change in the named executive officer's responsibilities, the registrant company must:

- describe and explain the specific circumstances that would trigger payment(s) or the provision of other benefits
- describe and quantify the estimated payments and benefits that would be provided in each circumstance, whether they would or could be lump sum, or annual, disclosing the duration, and by whom they would be provided



- describe and explain how the appropriate payment and benefit levels are determined under the various circumstances that trigger payments or provision of benefits
- describe and explain any material conditions or obligations applicable to the receipt of payments or benefits, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, including the duration of such agreements and provisions regarding waiver of breach of such agreements
- describe any other material factors regarding each such contract, agreement, plan or arrangement.

***Item 402(k): Compensation of directors***

Registrant companies must provide information concerning the compensation of the directors for the registrant's last completed fiscal year, as specified in the Table, including:

- the aggregate dollar amount of all fees earned or paid in cash for services as a director, including annual retainer fees, committee and/or chairmanship fees, and meeting fees
- for awards of stock, the aggregate grant date fair value
- for awards of options, the aggregate grant date fair value
- the dollar value of all earnings for services performed during the fiscal year pursuant to non-equity incentive plans
- the pension value and nonqualified deferred compensation earnings
- all other compensation for the covered fiscal year that the registrant could not properly report in any other column of the Director Compensation Table.

The registrant company must also provide a narrative description of any material factors necessary to an understanding of the director compensation disclosed in the Table. Various examples are given.

***Item 402(l)-(r): Smaller reporting companies***

A registrant that qualifies as a 'smaller reporting company' may provide scaled down disclosures, as set out in Item 402(m)-(r), in lieu of the requirements in Item 402(a)-(k).

***Item 402(s): Narrative disclosure of the registrant's compensation policies and practice as they relate to the registrant's risk management***

In proposing this additional Item in July 2009, the SEC stated that:

Critics have argued that, in some cases, the structure and the particular application of incentive compensation policies can create inadvertent incentives for management and employees to make decisions that significantly, and inappropriately, increase the company's risk, without adequate recognition of the risks to the company. Companies, and in turn investors, may be negatively impacted where the design or operation of their compensation programs creates incentives that influence behaviour inconsistent with the overall interests of the company.<sup>298</sup>

This Item, introduced in December 2009, provides as follows:

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<sup>298</sup> SEC Release Nos. 33-9052; 34-60289; C-28817; File No. S7-13-09 (July 2009) at 7-8.

To the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant, discuss the registrant's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives. While the situations requiring disclosure will vary depending on the particular registrant and compensation policies and practices, situations that may trigger disclosure include, among others, compensation policies and practices: at a business unit of the company that carries a significant portion of the registrant's risk profile; at a business unit with compensation structured significantly differently than other units within the registrant; at a business unit that is significantly more profitable than others within the registrant; at a business unit where compensation expense is a significant percentage of the unit's revenues; and that vary significantly from the overall risk and reward structure of the registrant, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the registrant from the task extend over a significantly longer period of time. The purpose of this paragraph(s) is to provide investors material information concerning how the registrant compensates and incentivizes its employees that may create risks that are reasonably likely to have a material adverse effect on the registrant. While the information to be disclosed pursuant to this paragraph(s) will vary depending upon the nature of the registrant's business and the compensation approach, the following are examples of the issues that the registrant may need to address for the business units or employees discussed:

- the general design philosophy of the registrant's compensation policies and practices for employees whose behaviour would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by employees on behalf of the registrant, and the manner of their implementation
- the registrant's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation
- how the registrant's compensation policies and practices relate to the realisation of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods
- the registrant's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile
- material adjustments the registrant has made to its compensation policies and practices as a result of changes in its risk profile, and
- the extent to which the registrant monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

## 9.2.2 Legislative initiatives

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, as passed by the US House of Representatives, is designed to introduce a range of changes to executive remuneration arrangements for registrant companies. They include shareholder voting on executive compensation and 'golden parachute' arrangements,<sup>299</sup> and requirements for independence of compensation committees and compensation consultants or advisers.<sup>300</sup> They also cover other aspects of compensation disclosure and remuneration arrangements, being:

<sup>299</sup> Section 951.

<sup>300</sup> Section 952.

### **Section 953. Executive compensation and disclosures**

(i) **DISCLOSURE OF PAY VERSUS PERFORMANCE.**—The Commission [SEC] shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer ... information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. The disclosure under this subsection may include a graphic representation of the information required to be disclosed.

(b) **ADDITIONAL DISCLOSURE REQUIREMENTS.**—

(1) **IN GENERAL.**—The Commission shall ... require each issuer to disclose—

(A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer;

(B) the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and

(C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B).

### **Section 954 Recovery of erroneously awarded compensation**

(b) **RECOVERY OF FUNDS.**—The rules of the Commission ... shall require each issuer to develop and implement a policy providing—

(1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

### **Section 955 Disclosure regarding employee and director hedging**

(j)—The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer whether any employee or member of the board of directors of the issuer, or any designee of such employee or member, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities—

(1) granted to the employee or member of the board of directors by the issuer as part of the compensation of the employee or member of the board of directors; or

(2) held, directly or indirectly, by the employee or member of the board of directors.

**Section 956 Enhanced compensation structure reporting****(a) ENHANCED DISCLOSURE AND REPORTING OF COMPENSATION ARRANGEMENTS.—**

(1) IN GENERAL.—Not later than 9 months after the date of enactment of this title, the appropriate Federal regulators jointly shall prescribe regulations or guidelines to require each covered financial institution<sup>301</sup> [other than an institution with assets of less than \$1,000 million] to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements offered by such covered financial institutions sufficient to determine whether the compensation structure—

- (A) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
- (B) could lead to material financial loss to the covered financial institution.

(2) RULES OF CONSTRUCTION.—Nothing in this section shall be construed as requiring the reporting of the actual compensation of particular individuals. Nothing in this section shall be construed to require a covered financial institution that does not have an incentive-based payment arrangement to make the disclosures required under this subsection.

**(b) PROHIBITION ON CERTAIN COMPENSATION ARRANGEMENTS.—**Not later than 9 months after the date of enactment of this title, the appropriate Federal regulators shall jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions—

- (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
- (2) that could lead to material financial loss to the covered financial institution.

**(c) STANDARDS.—**The appropriate Federal regulators shall—

- (1) ensure that any standards for compensation established under subsections (a) or (b) are comparable to the standards established under section of the *Federal Deposit Insurance Act* for insured depository institutions; and
- (2) in establishing such standards under such subsections, take into consideration the compensation standards described in ... the *Federal Deposit Insurance Act*.

**9.2.3 Guidance for banks on remuneration arrangements**

The Office of the Comptroller of the Currency (OCC) has issued *Guidance on Sound Incentive Compensation Policies*,<sup>302</sup> to assist US regulated banking organizations to design

<sup>301</sup> The term ‘covered financial institution’ includes various depository institutions, broker-dealers, credit unions, investment advisers and any other financial institution that Federal regulators determine shall be so treated for purposes of this section.

<sup>302</sup> Federal Register Vol. 75, No. 122, Friday June 25, 2010. The document was issued in conjunction with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.

and implement incentive compensation arrangements (ICAs)<sup>303</sup> for their senior executives<sup>304</sup> and various other employees<sup>305</sup> that do not encourage imprudent risk-taking and are consistent with the financial safety and soundness of the organization. The guidance came into effect on 25 June 2010.<sup>306</sup>

The OCC points out that ICAs can be useful tools in the successful management of banking organizations. However:

compensation arrangements can provide executives and employees with incentives to take imprudent risks that are not consistent with the long-term health of the organization. Flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.

The OCC considers that, to be consistent with financial safety and soundness, ICAs at banking organizations should be based on three key principles.

***First Principle: Balance.*** ICAs should provide incentives that appropriately balance risk and reward in a manner that does not encourage employees to expose their organizations to imprudent risk.

The guidance endorses four concepts to help ensure that ICAs appropriately balance risk and reward:

- risk adjustment of incentive payouts (i.e., the riskier the activity on which the award is based, the lower the payout relative to less risky activities)
- deferral of payment with potential clawbacks for performance or risk outcomes
- use of longer performance periods
- reduced leverage for short-term performance measures (i.e., the higher the short-term performance threshold, the slower the rate at which an incentive payment is earned).

The guidance recommends that incentive compensation for senior executives of large banking organizations be structured to involve deferral of a substantial portion of the executive's incentive compensation over a multi-year period, substantial use of multi-year performance periods, and payment of a significant portion of the incentive compensation in the form of equity-based instruments that vest over multiple years.

In addition (and although not banning them outright), the guidance is critical of severance and golden parachute arrangements that could result in large additional payments without

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<sup>303</sup> For the purpose of the guidance, incentive compensation is defined as any current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). It does not include base salary, awards that vest solely based on service and the passage of time, or arrangements (such as qualified retirement plans) to the extent benefits are accrued based on salary and not performance metrics.

<sup>304</sup> Senior executives are 'executive officers' under the Federal Reserve rules and 'named executive officers' under the SEC proxy reporting rules.

<sup>305</sup> Relevant employees include persons responsible for oversight of the banking organization's firm-wide activities or of material business lines, as well as persons who may expose the organization to material amounts of risk (such as traders with large position limits or loan officers who, as a group, can originate loans that account for material amounts of the organization's overall credit risk).

<sup>306</sup> OCC Bulletin (OCC 2010-24) *Incentive Compensation* 30 June 2010.

regard to risk outcomes or ‘golden handshake’ agreements that make up for forfeited incentive compensation an employee leaves behind when he or she moves to another firm.

***Second Principle: Controls.*** *ICAs should be compatible with effective controls and risk management.*

Banking organizations should have strong controls to ensure that their processes for establishing balanced ICAs are followed, including appropriate input from risk management personnel into the design and implementation of ICAs. These risk management personnel are expected to have appropriate skills and experience, and to be compensated based on their functions rather than the financial results or performance of their business unit.

***Third principle: Governance:*** *ICAs should be supported by strong corporate governance arrangements, including active and effective oversight by the organization’s board of directors.*

A banking organization’s board of directors (or appropriate board committee) should actively oversee the design and implementation of the organization’s ICAs, including to approve directly all ICAs for senior executives.

Members of the board or the committee responsible for this function are expected to have levels of expertise and experience in risk management at financial institutions, either individually or collectively, that is appropriate for the size of the organization and the complexity of its ICAs. Banking organizations (whether or not publicly traded) are expected to provide disclosure concerning their ICAs and risk management processes to their shareholders, for senior executives as well as other covered employees. For publicly traded organizations, this may extend beyond what is currently called for under similar SEC disclosure rules.

### ***Compliance***

The OCC states that it expects US national banking organizations to conduct regular reviews of:

- their ICAs for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk
- the risk management, control and corporate governance processes related to these arrangements.

Banking organizations should immediately address any identified deficiencies in their ICA arrangements or any processes that are inconsistent with safety and soundness.

The OCC considers that large banking organizations warrant the most intensive supervisory attention because they are significant users of ICAs and flawed approaches at these organizations are more likely to have adverse effects on the broader financial system.

## 10 Other international initiatives

*This chapter summarises initiatives by various international regulatory and private sector bodies regarding executive remuneration arrangements and their disclosure.*

### 10.1 OECD

The Organisation of Economic Co-operation and Development (OECD) *Principles of Corporate Governance* (2004), and related reports, are designed to assist governments in their efforts to evaluate and improve their corporate governance frameworks and to provide guidance for financial market participants and regulators. The OECD principles and reports constitute non-binding governance standards on which national regulators, boards and directors can draw.

#### 10.1.1 Principles of Corporate Governance

The OECD *Principles of Corporate Governance* cover the legal duties of the board, as well as its key functions, including in relation to corporate strategy, risk, and supervision of the company's financial and governance performance. The Principles also emphasise the role of the board in setting a company's ethical standards and the use of internal codes of conduct to maintain those standards.

One of the OECD principles is that:

... it is important for shareholders to know the specific link between remuneration and company performance when they assess the capability of the board and the qualities they should seek in nominees for the board.<sup>307</sup>

The OECD also observed that:

Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares.<sup>308</sup>

#### 10.1.2 OECD reports

The OECD report *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009) examined corporate governance practices in light of the instability in global financial markets in recent times. In relation to executive remuneration, the report commented that:

- The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length.
- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish. The use of company stock price as a single measure does not allow for the benchmarking of a company's specific performance against an industry or market average.

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<sup>307</sup> at 34.

<sup>308</sup> at 49.

- Defining the structure of remuneration/incentive schemes is a key aspect of corporate governance and companies need flexibility to adjust systems to their own circumstances. Such schemes are complex and the use of legal limits such as caps should be limited to specific and temporary circumstances. The balance between the fixed and variable components of remuneration packages should be carefully considered at company level, and the regulatory framework should not induce a shift towards excessive fixed remuneration components.
- Steps must be taken to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated. It should be considered good practice to give a significant role to non-executive independent board members in the process.
- In order to increase awareness and attention, it should be considered good practice to submit remuneration policies to the annual meeting and, as appropriate, to shareholder approval.

The follow-up OECD report *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles* (February 2010) sought to provide further guidance to boards on the matters contained in the OECD June 2009 report. In relation to executive remuneration, it stated that:

Executive remuneration has been an important public policy issue for some time. The report reinforces the position of the Principles that this is a responsibility of the board. It is important for boards first to set the strategic goals of the company and its associated risk appetite. They are then in a position to establish a compensation structure that meets a small number of performance metrics based on these goals. An explicit governance process needs to be established that will also define the role and duties of compensation consultants who are increasingly important. Good practice is for the process, remuneration structure and performance to be made transparent through some form of remuneration report. There also needs to be a possibility for shareholders to express their views about remuneration policy.

## 10.2 Financial Stability Board

In light of indications that compensation practices in some financial institutions may have exacerbated long-term risk by focusing on remuneration incentives to boost short-term profits, the Financial Stability Board (FSB), set up by the G20 in April 2009,<sup>309</sup> issued *Principles for Sound Compensation Practices* in April 2009. This was followed by *Implementation Standards* in September 2009, designed to provide specific guidance on remuneration governance, structure and disclosure in financial institutions and to strengthen adherence to the FSB's Principles.

The FSB Principles for Sound Compensation Practices are:

### **Effective governance of compensation**

Principle 1. The firm's board of directors must actively oversee the compensation system's design and operation.

Principle 2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.

<sup>309</sup> The Financial Stability Board was set up by the G20 in April 2009 as the successor body to the Financial Stability Forum, which was founded in 1999 by the G7 Finance Ministers and Central Bank Governors.



Principle 3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

**Effective alignment of compensation with prudent risk taking**

Principle 4. Compensation must be adjusted for all types of risk.

Principle 5. Compensation outcomes must be symmetric with risk outcomes.

Principle 6. Compensation payout schedules must be sensitive to the time horizon of risks.

Principle 7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

**Effective supervisory oversight and engagement by stakeholders**

Principle 8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.

Principle 9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

The FSB Implementation Standards are:

**Governance**

1. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should:

- be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the firm's financial condition and future prospects
- to that end, work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system
- ensure that the firm's compensation policy is in compliance with the FSB Principles and standards as well as complementary guidance by the Basel Committee, IAIS and IOSCO, and the respective rules by national supervisory authorities; and
- ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management and submitted to the relevant national supervisory authorities or disclosed publicly. Such a review should assess compliance with the FSB Principles and standards or applicable standards promulgated by national supervisors.

2. For employees in the risk and compliance function:

- remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff
- performance measures should be based principally on the achievement of the objectives of their functions.

### Compensation and capital

3. Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of a firm's current capital position. National supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.

### Pay structure and risk alignment

4. For significant financial institutions, the size of the variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular:

- the cost and quantity of capital required to support the risks taken
- the cost and quantity of the liquidity risk assumed in the conduct of business; and
- consistency with the timing and likelihood of potential future revenues incorporated into current earnings.

5. Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

6. For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:

- a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance
- a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and
- these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.

7. The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.

8. A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.

9. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.

10. In the event of exceptional government intervention to stabilise or rescue the firm:

- supervisors should have the ability to restructure compensation in a manner aligned with sound risk management and long-term growth; and

- compensation structures of the most highly compensated employees should be subject to independent review and approval.

11. Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.

12. Existing contractual payments related to a termination of employment should be re-examined, and kept in place only if there is a clear basis for concluding that they are aligned with long-term value creation and prudent risk-taking; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure.

13. Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.

14. Significant financial institutions should demand from their employees that they commit themselves not to use personal hedging strategies or compensation—and liability-related insurance to undermine the risk alignment effects embedded in their compensation arrangements. To this end, firms should, where necessary, establish appropriate compliance arrangements.

The FSB has also issued *Compensation Principles and Standards Assessment Methodology* (January 2010), designed to guide regulatory supervisors in reviewing compensation practices in individual firms.

### 10.3 Basel Committee on Banking Supervision

The Basel Committee *Compensation Principles and Standards Assessment Methodology* (January 2010) aims to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB *Principles for Sound Compensation Practices* and the *Implementation Standards* (see Section 10.2).

In March 2010, the Basel Committee released a consultative document *Principles for enhancing corporate governance* (for comment by 15 June 2010). Section D deals with compensation, based on two principles:

Principle 10 The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.

Principle 11 An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

### 10.4 Private sector bodies

#### 10.4.1 International Corporate Governance Network

The International Corporate Governance Network (ICGN), an organization comprising institutional investors, business leaders, policy makers and professional advisors, drawn world-wide, in March 2010, published guidelines and policies on non-executive director (NED) remuneration. The guidelines are primarily addressed to companies and their non-executive board members.

The ICGN provides the following guidance in relation to remuneration of NEDs:

*Transparency*—investors should be able to clearly understand the NEDs remuneration programme and see total remuneration for NEDs. NEDs remuneration should consist of a combination of a cash retainer and equity-based remuneration. The ICGN suggests that the remuneration programme and total pay information be disclosed in tabular form in the annual proxy statement. The Remuneration Committee report should include a discussion of the reasons for the programme and any changes in the programme should be explained.

*Accountability*—the Remuneration Committee should annually review total remuneration potentially payable to each NED and consult external advisers for their advice on their remuneration plans. Where external advice is obtained, an independent remuneration consultant should be used.

*Alignment of interests between NEDs and shareholders*—the ICGN comments that policy issues related to NED remuneration are fundamentally different from executive remuneration and that a non-executive remuneration programme should align the interests of directors through the attainment of significant equity holdings in the company meaningful to each individual director. The programme should consist solely of a combination of cash retainer and equity-based remuneration and should not include the use of options or option-like equity remuneration. Companies should have the flexibility to set and adjust the ratio of equity and cash based remuneration as appropriate.

The ICGN policies on NED remuneration include the following:

- an annual retainer/fee should be the preferred form of cash remuneration paid to a NED and should reflect the level of expected duties of the director
- equity-based remuneration should be fully vested in the director on the grant date. The value of the equity on the grant date should be fully disclosed in the proxy statement
- NED remuneration should not be performance-based as this has the potential to conflict with the independent nature of a NED
- in relation to perquisites, only meeting-related expenses should be met
- NEDs should never participate in or be eligible for share or option repricing or exchange programs or receive any severance payments or retirement benefits
- NEDs should be required to repay remuneration in the event of malfeasance or breach of fiduciary duty.

#### **10.4.2 Corporate Secretaries International Association**

In March 2010, the Corporate Secretaries International Association published *Twenty practical steps to better corporate governance*. Number 14 is:

##### **Ensure that directors' remuneration packages are justifiable and justified**

Of all the issues to arise from the global financial crisis, the apparent abuse by directors of their privileged position by awarding themselves massive remuneration packages unrelated to performance, have attracted the most interest and derision from the media and the public. Some director's remuneration and severance payments have seemed at times to reward failure.

This dilemma has not been restricted to financial institutions. Robert Monks, a commentator on the American corporate governance scene, provided a devastating

account of corporate greed, with hugely inflated CEO salaries and the wholesale exclusion of shareholders from governance. He suggests that this is symptomatic of a greater threat—the corporate takeover of the political process.

Professor Mallin pointed out that “executive remuneration packages seem often not to be related to the company’s performance, nor to that of the individual director.” This, she felt, resulted in over-generous payments or payments for poor performance, or indeed both. She questioned the role of remuneration committees, suggesting that some had contributed to the problem. “How might the situation be ameliorated?”, she asked.

This is a corporate governance issue that will have to be addressed in many regulatory jurisdictions. The proposed changes to the UK Corporate Governance Code call for performance-related pay to be aligned to the company’s long-term interests and its policy on risk. Expectations are running high in many countries for greater transparency and confirmation that top-level remuneration packages are justified.

In the conclusion to the document, the Association refers to ‘ensuring that directors’ remuneration packages are justifiable and justified’.



## Appendix 1 Letter from the Minister for Financial Services, Superannuation and Corporate Law

Ms Joanne Rees  
Convenor  
Corporations and Markets Advisory Committee  
GPO Box 3967  
SYDNEY NSW 2001

Dear Joanne

I am writing to refer an aspect of Australia's executive remuneration framework to the Corporations and Markets Advisory Committee for its consideration and advice.

As you may be aware, the Productivity Commission (PC) recently released a report examining the director and executive remuneration framework in Australia. The Government commissioned the inquiry in March 2009, as part of its broader response to community concerns about inappropriate remuneration practices.

The PC's broad ranging terms of reference enabled it to undertake an extensive review spanning all aspects of Australia's remuneration framework applying to listed companies. The report concluded that Australia's corporate governance and remuneration frameworks are ranked highly internationally. However, the report makes a number of recommendations that are designed to further strengthen Australia's remuneration framework.

One of these recommendations relates to the annual remuneration report that companies are required to prepare under the Corporations Act 2001 (Corporations Act). The PC's report concluded that the usefulness of remuneration reports has been diminished by their complexity, placing a significant burden on companies and leading investors to find it impenetrable and sometimes misleading. Additionally, some information of use to shareholders—for example, pay as actually realised by executives—is not required to be reported.

The PC recommended that the Australian Government establish an expert panel under the auspices of the Australian Securities and Investments Commission (ASIC) to advise on how best to revise the legislation in regard to remuneration reports. In the Government's response to the PC report, released on 16 April 2010, it supported this recommendation but noted that, in CAMAC, the Government already had access to a suitably experienced advisory panel capable of providing advice on the relevant legislation.

In the course of its inquiry, the PC undertook extensive analysis on remuneration reports and the evolution of disclosure requirements in their current form. The PC's report contains a substantial amount of detailed information which should be of use to CAMAC. Detailed analysis of the work undertaken by the PC is contained in Chapter 8 and in the Annexe to the Report.

A separate but related issue is the importance of aligning executive remuneration with company performance and the usefulness of 'at risk' remuneration in achieving this aim.

Highly complex remuneration schemes can obscure this nexus between performance and pay. The Government would therefore also like CAMAC to provide recommendations on how the incentive components of executive pay arrangements could be simplified in order to improve transparency and strengthen the correlation between the interests of a company's executives and the interests of its shareholders.

I request that CAMAC:

- examine the existing reporting requirements contained in section 300A of the Corporations Act and related regulations and identify areas where the legislation could be revised in order to reduce its complexity and more effectively meet the needs of shareholders and companies;
- examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements; and
- make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports and simplify the incentive components of executive remuneration arrangements.

A number of stakeholders provided submissions to the PC in relation to this issue. These stakeholders included the Australian Institute of Company Directors (AICD), the major accounting firms and remuneration advisors. It would be appropriate for CAMAC to consult with these stakeholders in developing its recommendations, as well as the Treasury which is responsible for the legislative architecture.

I look forward to receiving your report by 30 November 2010.

Yours sincerely

CHRIS BOWEN



## Appendix 2 Extracts from Corporations Act

### 300A Annual directors' report—specific information to be provided by listed companies

(1) The directors' report for a financial year for a company must also include (in a separate and clearly identified section of the report):

- (a) discussion of:
  - (i) board policy for determining, or in relation to, the nature and amount (or value, as appropriate) of remuneration of the key management personnel for the company; and
  - (ii) if consolidated financial statements are required—board policy in relation to the nature and amount (or value, as appropriate) of remuneration of the key management personnel for the consolidated entity; and
- (b) discussion of the relationship between such policy and the company's performance; and
- (ba) if an element of the remuneration of a member of the key management personnel for the company, or if consolidated financial statements are required, for the consolidated entity is dependent on the satisfaction of a performance condition:
  - (i) a detailed summary of the performance condition; and
  - (ii) an explanation of why the performance condition was chosen; and
  - (iii) a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen; and
  - (iv) if the performance condition involves a comparison with factors external to the company:
    - (A) a summary of the factors to be used in making the comparison; and
    - (B) if any of the factors relates to the performance of another company, of 2 or more other companies or of an index in which the securities of a company or companies are included—the identity of that company, of each of those companies or of the index; and
- (c) the prescribed details in relation to the remuneration of:
  - (i) if consolidated financial statements are required—each member of the key management personnel for the consolidated entity; and

- (ii) if consolidated financial statements are not required—each member of the key management personnel for the company; and
  - (iii) if consolidated financial statements are required—each of the 5 named relevant group executives who receive the highest remuneration for that year; and
  - (iv) in any case—each of the 5 named company executives who receive the highest remuneration for that year; and
- (d) if an element of the remuneration of a person referred to in paragraph (c) consists of securities of a body and that element is not dependent on the satisfaction of a performance condition—an explanation of why that element of the remuneration is not dependent on the satisfaction of a performance condition; and
- (da) if an element of the remuneration of a person referred to in paragraph (c) consists of securities of a body—discussion of board policy in relation to the person limiting his or her exposure to risk in relation to the securities, and the mechanism to enforce the policy; and
- (e) for each person referred to in paragraph (c):
  - (i) an explanation of the relative proportions of those elements of the person's remuneration that are related to performance and those elements of the person's remuneration that are not; and
  - (ii) the value (worked out as at the time they are granted and in accordance with any applicable accounting standards) of options that are granted to the person during the year as part of their remuneration; and
  - (iii) the value (worked out as at the time they are exercised) of options that were granted to the person as part of their remuneration and that are exercised by the person during the year; and
  - (iv) if options granted to the person as part of their remuneration lapse during the financial year because a condition required for the options to vest was not satisfied—the value of those options (worked out as at the time the options lapse, but assuming that the condition was satisfied); and
  - (vi) the percentage of the value of the person's remuneration for the financial year that consists of options; and
  - (vii) if the person is employed by the company under a contract—the duration of the contract, the periods of notice required to terminate the contract and the termination payments provided for under the contract; and
- (f) such other matters related to the policy or policies referred to in paragraph (a) as are prescribed by the regulations.

If a person is covered by more than one subparagraph in paragraph (c), details of the person's remuneration are only required in the report under one subparagraph of that paragraph.

(1AA) Without limiting paragraph (1)(b), the discussion under that paragraph of the company's performance must specifically deal with:

- (a) the company's earnings; and
- (b) the consequences of the company's performance on shareholder wealth;

in the financial year to which the report relates and in the previous 4 financial years.

(1AB) In determining, for the purposes of subsection (1AA), the consequences of the company's performance on shareholder wealth in a financial year, have regard to:

- (a) dividends paid by the company to its shareholders during that year; and
- (b) changes in the price at which shares in the company are traded between the beginning and the end of that year; and
- (c) any return of capital by the company to its shareholders during that year that involves:
  - (i) the cancellation of shares in the company; and
  - (ii) a payment to the holders of those shares that exceeds the price at which shares in that class are being traded at the time when the shares are cancelled; and
- (d) any other relevant matter.

(1A) The material referred to in subsection (1) must be included in the directors' report under the heading "Remuneration report".

(1AAA) For the purposes of subsection (1), key management personnel has the same meaning as in the accounting standards.

(1B) For the purposes of paragraph (1)(c):

- (a) a person is a company executive of the company if the person is a secretary or senior manager of the company; and
- (b) a person is a relevant group executive of the company if the person:
  - (i) is a group executive of the consolidated entity; and
  - (ii) is not a director of the company.

(1C) Without limiting paragraph (1)(c), the regulations may:

- (a) provide that the value of an element of remuneration is to be determined, for the purposes of this section, in a particular way or by reference to a particular standard; and

- (b) provide that details to be given of an element of remuneration must relate to the remuneration provided in:
  - (i) the financial year to which the directors' report relates; and
  - (ii) the earlier financial years specified in the regulations.
- (2) This section applies to any disclosing entity that is a company.
- (3) This section applies despite anything in the company's constitution.
- (4) For the purposes of this section, if:
  - (a) consolidated financial statements are required; and
  - (b) a person is a group executive who is a group executive of 2 or more entities within the consolidated entity;

the person's remuneration is taken to include all of the person's remuneration from those entities (regardless of the capacity in which the person received the remuneration).

### **s 9 definition of 'senior manager'**

senior manager:

- (a) in relation to a corporation—means a person (other than a director or secretary of the corporation) who:
  - (i) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
  - (ii) has the capacity to affect significantly the corporation's financial standing; and
- (b) in relation to a partnership—means a person (other than a partner) who:
  - (i) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the partnership; or
  - (ii) has the capacity to affect significantly the partnership's financial standing; and
- (c) in relation to a trust—means a person (other than a trustee) who:
  - (i) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business or affairs of the trust; or
  - (ii) has the capacity to affect significantly the financial standing of the trust; and
- (d) in relation to a joint venture—means a person (other than a director or secretary of a corporation participating in the joint venture) who:
  - (i) makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the joint venture; or

- (ii) has the capacity to affect significantly the financial standing of the joint venture.

**s 9 definition of ‘group executives’**

group executives for a consolidated entity means:

- (a) the directors of the companies or bodies within the consolidated entity; and
- (b) the secretaries of the companies or bodies within the consolidated entity; and
- (c) the senior managers of any corporation within the consolidated entity; and
- (d) the partners, and senior managers, of any partnership within the consolidated entity; and
- (e) the trustees, and senior managers, of any trusts within the consolidated entity; and
- (f) the senior managers of any joint venture within the consolidated entity.



## Appendix 3 Extracts from Corporations Regulations

### 2M.3.03 Prescribed details (Act s 300A)

(1) For paragraph 300A (1) (c) of the Act, the details set out in the table relating to a person are prescribed.

Item	Condition (if any)	Details
<b>General</b>		
1		The person's name
2		Each position held by the person in the financial year
3	If the person has held a position mentioned in item 2 for less than the whole financial year	(a) The date on which the person began holding the position (b) The date (if any) on which the person ceased to hold the position
4	If there has been a change in the chief executive officer or a director of the entity during the period: (a) starting immediately after the reporting date; and (b) ending immediately before the date on which the financial report is authorised for issue	(a) The name of each person involved in the change (b) The position involved (c) The date on which the change occurred
5	If a person (other than a director or chief executive officer) has retired during the period: (a) starting immediately after the reporting date; and (b) ending immediately before the date on which the financial report is authorised for issue	(a) The person's name (b) The position involved (c) The date on which the retirement took effect
<b>Payments and benefits</b>		
6	<i>Note</i> See subregulation (2).	The person's short-term employee benefits, divided into at least the following components: (a) cash salary, fees and short-term compensated absences; (b) short-term cash profit-sharing and other bonuses; (c) non-monetary benefits; (d) other short-term employee benefits
7	<i>Note</i> See subregulation (2).	The person's post-employment benefits, divided into at least the following components: (a) pension and superannuation benefits; (b) other post-employment benefits
8	<i>Note</i> See subregulation (2).	The person's long-term employee benefits other than benefits mentioned in items 6 and 7, separately identifying any amount attributable to a long-term incentive plan
9	<i>Note</i> See subregulation (2).	The person's termination benefits
10	For any position the person started to hold during the financial year	Payments (if any) made to the person, before the person started to hold the position, as part of the consideration for the person agreeing to hold the position, including: (a) the monetary value of the payment; and (b) the date of the payment
11	<i>Note</i> See subregulation (2).	Share-based payments made to the person, divided into at least the following components: (a) equity-settled share-based payment transactions, showing separately: (i) shares and units; and (ii) options and rights;

Item	Condition (if any)	Details
		<ul style="list-style-type: none"> <li>(b) cash-settled share-based payment transactions;</li> <li>(c) all other forms of share-based payment compensation (including hybrids)</li> </ul>
<b>Compensation</b>		
12	For each grant of a cash bonus, performance-related bonus or share-based payment compensation benefit made to a person, whether part of a specific contract for services or not	<p>The terms and conditions of each grant affecting compensation in the reporting period or a future reporting period, including the following:</p> <ul style="list-style-type: none"> <li>(a) the grant date;</li> <li>(b) the nature of the compensation granted;</li> <li>(c) the service and performance criteria used to determine the amount of compensation;</li> <li>(d) if there has been any alteration of the terms or conditions of the grant since the grant date—the date, details and effect of each alteration;</li> <li>(e) the percentage of the bonus or grant for the financial year that was paid to the person, or that vested in the person, in the financial year;</li> <li>(f) the percentage of the bonus or grant for the financial year that was forfeited by the person (because the person did not meet the service and performance criteria for the bonus or grant) in the financial year;</li> <li>(g) the financial years, after the financial year to which the report relates, for which the bonus or grant will be payable if the person meets the service and performance criteria for the bonus or grant;</li> <li>(h) estimates of the maximum and minimum possible total value of the bonus or grant (other than option grants) for financial years after the financial year to which the report relates</li> </ul>
13	For each contract for services between a person and the disclosing entity (or any of its subsidiaries)	<p>Any further explanation that is necessary in addition to those prescribed in paragraph 300A (1) (ba) of the Act and item 12 to provide an understanding of:</p> <ul style="list-style-type: none"> <li>(a) how the amount of compensation in the current reporting period was determined; and</li> <li>(b) how the terms of the contract affect compensation in future periods</li> </ul>
14	If the terms of share-based payment transactions (including options or rights) granted as compensation to key management personnel have been altered or modified by the issuing entity during the reporting period	<ul style="list-style-type: none"> <li>(a) The date of the alteration</li> <li>(b) The market price of the underlying equity instrument at the date of the alteration</li> <li>(c) The terms of the grant of compensation immediately before the alteration, including: <ul style="list-style-type: none"> <li>(i) the number and class of the underlying equity instruments, exercise price; and</li> <li>(ii) the time remaining until expiry; and</li> <li>(iii) each other condition in the terms that affects the vesting or exercise of an option or other right</li> </ul> </li> <li>(d) The new terms</li> <li>(e) The difference between: <ul style="list-style-type: none"> <li>(i) the total of the fair value of the options or other rights affected by the alteration immediately before the alteration; and</li> <li>(ii) the total of the fair value of the options or other rights immediately after the alteration</li> </ul> </li> </ul>
15	If options and rights over an equity instrument issued or issuable by the disclosing entity or any of its subsidiaries have been provided as compensation to a person during the reporting period <i>Note</i> See subregulation (3).	<ul style="list-style-type: none"> <li>(a) The number of options and the number of rights that: <ul style="list-style-type: none"> <li>(i) have been granted; and</li> <li>(ii) have vested; during the reporting period</li> </ul> </li> <li>(b) The terms and conditions of each grant made during the reporting period, including: <ul style="list-style-type: none"> <li>(i) the fair value per option or right at grant date; and</li> <li>(ii) the exercise price per share or unit; and</li> </ul> </li> </ul>



Item	Condition (if any)	Details
		(iii) the amount, if any, paid or payable by the recipient; and (iv) the expiry date; and (v) the date or dates when the options or rights may be exercised; and (vi) a summary of the service and performance criteria that must be met before the beneficial interest vests in the person
16	If an equity instrument that is issued or issuable by the disclosing entity or any of its subsidiaries has been provided as a result of the exercise during the reporting period of options and rights that have been granted as compensation to a person <i>Note</i> See subregulation (3).	(a) The number of equity instruments (b) If the number of options or rights exercised differs from the number of equity instruments disclosed under paragraph (a)—the number of options or rights exercised (c) The amount paid per instrument (d) The amount unpaid per instrument

(2) For items 6, 7, 8, 9 and 11 of the table:

- (a) the information of the kind described in the item for the previous financial year must also be disclosed in the financial year to which the item relates (to give comparative information for the purposes of the item); but
- (b) paragraph (a) does not apply in relation to the first financial year in which paragraph 300A (1) (c) of the Act applies in relation to a person.

*Note* The effect of paragraph (b) is that no comparative information is required in the first period of reporting on a specific individual.

(3) For items 15 and 16 of the table, a disclosure required by the item must:

- (a) be separated into each class of equity instrument; and
- (b) identify each class of equity instrument by:
  - (i) the name of the issuing entity;
  - (ii) the class of equity instrument; and
  - (iii) if the instrument is an option or right—the class and number of equity instruments for which it may be exercised.

(4) For subregulation (1), a company must apply the requirements of relevant accounting standards when disclosing the information mentioned in the subregulation.

(5) In subregulation (1), an expression that is:

- (a) used in the subregulation; and
- (b) defined in a relevant accounting standard that is applied for the purpose of disclosing information;

has the meaning given by that accounting standard.