



Australian Government

Corporations and Markets
Advisory Committee

Executive Remuneration

Report

April
2011

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29 April 2011

The Hon. David Bradbury MP
Parliamentary Secretary to the Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Bradbury

I am pleased to present a report by the Advisory Committee on remuneration arrangements and remuneration reporting for directors and other key management personnel of entities subject to the financial reporting requirements of the Corporations Act.

Yours sincerely

A handwritten signature in black ink, appearing to read 'J. Rees', written in a cursive style.

Joanne Rees
Convenor

Contents

1	Introduction	1
1.1	Reference to the Committee	1
1.2	The review process	3
1.3	Outline of the report	5
1.4	Advisory Committee.....	11
2	Remuneration arrangements	15
2.1	The issue	15
2.2	Current position	16
2.3	CAMAC consideration	27
2.4	Other matters raised in submissions	53
3	Remuneration reporting	55
3.1	The context	55
3.2	Current requirements	57
3.3	Purpose of the remuneration report	68
3.4	Possible regulatory approaches.....	69
3.5	Remuneration governance framework.....	79
3.6	Persons covered	81
3.7	Remuneration policy.....	83
3.8	Relationship between remuneration policy and corporate performance	87
3.9	Performance conditions	90
3.10	Performance/non-performance remuneration mix.....	96
3.11	Incentives and corporate risk	98
3.12	Application of accounting standards	99
3.13	Valuing future-vesting equity-based remuneration at the time of grant.....	106
3.14	Options	109
3.15	Compensation	111

3.16	Presentation of data on prior year remuneration.....	113
3.17	Tracking deferred remuneration	114
3.18	Benefits on termination.....	116
3.19	Pay parity disclosure.....	119
3.20	Remuneration outcomes	121
Appendix 1	Terms of reference	125
Appendix 2	Suggestions for content of the remuneration report	127

1 Introduction

This chapter describes the scope of the reference, outlines the review process, and summarises the approach taken by CAMAC on matters concerning remuneration arrangements and remuneration reporting for directors and other key management personnel.

1.1 Reference to the Committee

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

Remuneration reporting

In his letter, the Minister referred to the report that companies (other than small proprietary companies) are required to prepare each year under s 300A of the Corporations Act and Corporations Regulation 2M.3.03 concerning the remuneration of their key management personnel, being the executive and non-executive directors and other persons having managerial authority.

In that context, the Minister 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 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.

Remuneration arrangements

In his letter, the Minister referred to the significance of the incentive components of these 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.¹

The Minister 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.

1.2 The review process

To invite and facilitate submissions from interested parties on the matters referred to CAMAC concerning the remuneration of directors and other key management personnel (executive remuneration), the Committee published an *Information paper* in July 2010. The paper is available on the CAMAC website.

That paper set out the approaches taken in Australia and in some other jurisdictions, by regulatory and other means, to:

¹ Australian Government Response To the Productivity Commission's Inquiry on Executive Remuneration in Australia (April 2010), p 1.

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

In response to the invitation in the *Information paper*, CAMAC received submissions from:

- Chartered Secretaries Australia (CSA)
- Ernst & Young
- the Australian Institute of Company Directors (AICD)
- the Business Council of Australia (BCA)
- Macquarie Group Limited
- Freehills
- ISS Governance Services (ISS)
- Guerdon Associates Pty Ltd (in conjunction with Allens Arthur Robinson)
- the Australian Bankers' Association (ABA)
- BHP Billiton
- the Law Council of Australia
- the Australian Shareholders' Association (ASA)
- Kym Sheehan
- Maxumise Consulting
- KPMG
- UniSuper Management Pty Ltd (UniSuper)
- Origin Energy
- the Australian Council of Superannuation Investors (ACSI).

All these submissions are published on the CAMAC website.

CAMAC also convened a Roundtable in December 2010 to discuss matters related to executive remuneration reporting. More than 40 persons participated at the Roundtable, comprising representatives from the Australian Accounting Standards Board (AASB), ABA,

ACSI, AICD, Allens Arthur Robinson, ASA, ASIC, the ASX Corporate Governance Council, BCA, BHP Billiton, CGI Glass Lewis, CSA, Ernst & Young, Freehills, Group of 100, Guerdon Associates, ICA, ISS, KPMG, the Law Council of Australia, Macquarie Group Limited, Mercer, NAB, Origin Energy, PWC, Regnan, Telstra, Treasury, UniSuper, and Kym Sheehan of the University of Sydney.

CAMAC was greatly assisted in its consideration of issues related to remuneration arrangements and remuneration reporting by the information and views provided in submissions and at the Roundtable. The Committee expresses its appreciation to all those who participated in this consultation process.

1.3 Outline of the report

This report deals with remuneration arrangements and remuneration reporting for directors and other key management personnel of entities that are subject to the financial reporting requirements of the Corporations Act.²

It does not consider remuneration arrangements within public sector entities and how they are reported, which are matters for government. Similarly, remuneration arrangements for small proprietary companies are generally a matter for shareholders.³ Also, the report does not consider fiscal policies concerning remuneration outcomes.

At the time of settlement of this report, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* was still before Parliament. That Bill contained various provisions concerning executive remuneration arrangements and remuneration reporting, including the ‘two-strikes and re-election process’ (two strikes rule), whereby shareholders would be given the opportunity to vote out a company’s directors if the company’s annual remuneration report received at least 25% ‘no’

² Those entities are specified in s 292(1).

³ For small proprietary companies see ss 292(2), 293. ASIC may give a direction to a particular small proprietary company to comply with the financial reporting requirements: s 294.

votes by shareholders voting on the report (either in person or by proxy) at two consecutive annual general meetings.

CAMAC was not asked to advise on matters in the Bill. However, for the purpose of considering the reference to CAMAC, this report assumes that the matters set out in the Bill, in particular the two strikes rule, will be enacted in the form contained in the Bill.

1.3.1 Remuneration arrangements (Chapter 2)

CAMAC considers that the incentive and other components of remuneration policies and arrangements for directors and other key management personnel are, in general, matters for each company to determine. Information on these matters is set out in the remuneration report on which shareholders vote at each annual general meeting.

The Government has supported a number of proposals to regulate remuneration arrangements that were put forward in the Productivity Commission report *Executive Remuneration in Australia* (December 2009) (the PC report). Some of those proposals are included in the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*. The ASX has also foreshadowed changes to its listing rules concerning remuneration committees of larger listed entities.

Various legislative and other regulatory initiatives have been introduced in overseas jurisdictions concerning permissible remuneration arrangements, particularly in the financial sector. These interventions have been in response to specific factors affecting the financial markets of these jurisdictions. APRA has provided direction and guidance on these matters for financial institutions in Australia.

Beyond these matters, CAMAC is of the view that boards of companies, assisted by their remuneration committees and, in some instances, external remuneration consultants, are best placed to determine the particular remuneration arrangements for each of their key management personnel that would promote the interests of the company and its shareholders.

In making those determinations, each board may need to consider a range of factors depending upon the company's circumstances,

including the strategic objectives of the company, the key drivers of its performance, its corporate culture, the commercial and financial risks and challenges that it faces, the experience, skills and responsibilities of its senior management, the marketplace for executive talent and the expectations of shareholders and other stakeholders of the company.

Boards will need to consider how remuneration arrangements will affect both the immediate performance and the longer-term prospects of the company. Whether, or the extent to which, incentive components for all or some key management personnel will promote the company's performance and prospects, and the nature of any such incentive components, are matters for each company to determine. Just as suitable remuneration arrangements can have a beneficial effect, poorly or inappropriately designed arrangements can damage the reputation or financial viability of a company, adversely affecting shareholders, employees, creditors and others having dealings with it. Matters of remuneration design require close consideration by each board and cannot be satisfactorily dealt with by prescriptive legislative requirements for all companies.

Shareholders can question directors on the purpose and outcome of their remuneration policies and arrangements and vote on the remuneration report at each annual general meeting. A significant 'no' vote on the remuneration report, particularly if it activates the two strikes rule, can place the position of board members in doubt.

The general view of respondents was that companies should determine their own remuneration arrangements, free of legislative attempts to simplify or otherwise prescribe the incentive or other components of these arrangements. These respondents reflected a cross-section of the commercial community, including industry bodies, professional firms, shareholder interests, proxy advisers, remuneration consultants, corporate entities and commentators.

Considerable guidance for boards in designing remuneration arrangements best suited to the particular needs of their companies is provided by various regulatory and private sector bodies in Australia, referred to in Chapter 2.

1.3.2 Remuneration reporting (Chapter 3)

Legislative re-design or specific changes

In response to the questions concerning remuneration reporting set out in the terms of reference, CAMAC considered a range of approaches involving either replacing the existing legislative reporting architecture with a principles-based or other simplified legislative structure or maintaining the existing provisions, subject to various amendments.

CAMAC considers that, while some well-developed simplification proposals have been put forward, this is not the time to undertake major legislative changes to the remuneration reporting requirements, given the foreshadowed introduction of the two strikes rule under the 2011 Bill. Remuneration reporting practices are likely to change or evolve significantly over the next few years in response to that rule. Once the two strikes rule has been in operation for some time, it may be appropriate to draw on evolving remuneration reporting practice, and the simplification proposals, as the basis for a non-prescriptive approach to remuneration reporting to replace s 300A of the Corporations Act and Corp Reg 2M.3.03.

As a more immediate measure, CAMAC recommends various specific amendments to s 300A and the Regulation, in response to particular concerns about the current remuneration reporting framework. These recommendations are summarised below.

CAMAC considers that the further step of a detailed rewrite of the requirements in s 300A and the Regulation may not prove to be productive or useful. Prescriptive legislation of this nature can, over time, become unaligned with ongoing developments in remuneration practices and lead to a divergence between reporting requirements and the disclosures that would most usefully inform shareholders.

Specific amendments

CAMAC recommends the following amendments to the legislative architecture for remuneration reporting.

(i) Remuneration governance framework

Section 300A should include a requirement that companies set out in the remuneration report a general description of their remuneration governance framework (unless some or all of this information is

otherwise disclosed in the annual report, in which case a cross-reference in the remuneration report would suffice).

CAMAC considers that shareholders are entitled to this basic corporate governance information.

(ii) Relationship between remuneration policy and corporate performance

Subsections 300A(1AA) and (1AB) should be repealed.

CAMAC considers that s 300A(1)(a) and (b) provide a sufficient disclosure framework for the link between remuneration policy and corporate performance. The additional details required by s 300A(1AA) and (1AB) are unduly prescriptive, without adding any significant benefit.

(iii) Performance conditions

Section 300A should be amended to permit a company to exclude from its remuneration report commercially sensitive information concerning a performance condition, provided that the report discloses the fact that information of this nature has been omitted and provides a general description of the omitted information.

Currently, there is no exemption for confidential price-sensitive information. CAMAC considers that such an exemption is necessary to protect information from disclosure where there are legitimate commercial grounds for keeping it confidential. Also, the lack of this exemption may unduly inhibit companies in developing performance conditions appropriate to their needs.

(iv) Application of accounting standards

Subparagraph 300A(1)(e)(ii) should be amended to remove the reference to the accounting standards. Also, Corp Reg 2M.3.03(4) should be repealed.

CAMAC is of the view that the application of accounting methodology to the remuneration report can confuse and mislead shareholders, without providing them with additional useful information.

(v) Role of the external auditor

Subsection 308(3C) should be reworded to require that the external auditor give an opinion on the accuracy of the calculations in a remuneration report.

The current requirement in subsection 308(3C) relates more generally to compliance with the reporting requirements in s 300A, which include the application of the accounting standards methodology. Although CAMAC has reached the view that the accounting standards should no longer continue to apply to remuneration reports, it is desirable to have an independent check on the accuracy of calculations included in those reports.

(vi) Valuing future-vesting equity-based remuneration

Corp Reg 2M.3.03 should be amended to require a company to disclose, in the financial year in which future-vesting equity-based remuneration was granted:

- the methodology chosen by the company to value that remuneration at the time of grant, and
- the number of securities granted as a result of the application of that valuation methodology.

CAMAC considers that companies should be free to choose the methodology for valuing this form of remuneration. However, the remuneration report should disclose that methodology and its outcomes.

(vii) Options

Section 300A should be amended to require that the remuneration report disclose any options that have lapsed in the current financial year and indicate the year(s) in which they were granted. There should be no obligation to include a value for the lapsed options.

CAMAC considers that these disclosures would provide shareholders with more meaningful information on lapsed options.

Also, the obligation in s 300A(1)(e)(vi) to disclose the percentage of the value of remuneration that consists of options should be repealed. This requirement is already covered by Item 15 of Corp Reg 2M.3.03.

(viii) Benefits on termination

Subparagraph 300A(1)(e)(vii) should be amended to require the disclosure of all payments for key management personnel upon their retirement from the company, whether or not those payments were provided for under a contract of employment.

CAMAC considers that the remuneration report should disclose, for each individual, the total benefits under *entitlement payments* (amounts paid on termination that reflect statutory and other accumulated payments) and *severance payments* (amounts paid specifically for termination, including gratuitous and discretionary payments) respectively, with a further breakdown under each component within both categories where applicable. A separate summary of any *post-severance arrangements* should also be included. This would ensure that shareholders are informed about all the financial consequences of a termination.

(ix) Remuneration outcomes

Section 300A should be amended to require that the remuneration report disclose, for each of the key management personnel:

- remuneration that was granted to that person at some previous time (whether conditional or unconditional) and is paid in the current financial year (crystallized past pay)
- remuneration that is granted to that person in the current financial year and is paid in that year (present pay)
- conditional or unconditional remuneration entitlements, payment of which is deferred to some future period (future pay).

CAMAC considers that mandatory disclosure of each of these remuneration elements would ensure that shareholders of all companies are given appropriate information on remuneration outcomes.

1.4 Advisory Committee

CAMAC 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 CAMAC 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 CAMAC 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.

A Legal Committee has been constituted to provide expert legal analysis, assessment and advice to CAMAC in relation to such matters as are referred to it by CAMAC.

The members of the Legal Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their expertise in corporate law.

The members of the Legal Committee are:

- Greg Vickery AM (Convenor)—Special Counsel, Norton Rose Australia, Brisbane

- Lyn Bennett—Partner, Hunt & Hunt, Darwin
- Elizabeth Boros—Barrister-at-Law, Melbourne
- Damian Egan—Partner, Murdoch Clarke, Hobart
- Jennifer Hill—Professor of Law, University of Sydney
- James Marshall—Partner, Blake Dawson, Sydney
- David Proudman—Partner, Johnson Winter & Slattery, Adelaide
- Simon Stretton—Judge of the District Court of South Australia, Adelaide
- Rachel Webber—Special Counsel, Jackson McDonald, Perth.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Remuneration arrangements

This chapter considers the remuneration setting framework for key management personnel, including whether the legislative architecture should be revised to simplify the incentive components of these remuneration arrangements.

2.1 The issue

The responsibility for settling the remuneration arrangements for directors and other key management personnel of listed companies usually rests with the boards of those companies, assisted by their remuneration committees.

There are limited legislative controls on the content of remuneration arrangements, though the Government has introduced some initiatives in response to the PC report (see Section 2.2.1). Currently, the primary legislative focus is on the obligation of boards to disclose remuneration arrangements to shareholders in the remuneration report (which is part of the annual report), with shareholders having a non-binding vote on adoption of the remuneration report.

The most prominent regulatory intervention into the remuneration setting process has been the standards and guidance on remuneration arrangements issued by the Australian Prudential Regulation Authority (APRA), applicable to Australian banking and other financial institutions. For listed entities generally, in addition to requirements under various Listing Rules, guidance is provided by the Australian Securities Exchange (ASX) Corporate Governance Council in its *Principles and Recommendations* and by various industry and other private sector bodies.

The quantum and other details of remuneration packages remain a matter for each company. There has been no legislative attempt to impose monetary limits or caps on payments or entitlements.

The reference from the Minister has asked 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, and
- make recommendations on how best to revise the legislative architecture to simplify the incentive components of executive remuneration arrangements.

2.2 Current position

2.2.1 Corporations Act

Current provisions

The procedure for settling the remuneration of executive and non-executive directors is a matter for each company. The directors of companies that choose to be governed by the replaceable rules contained in the Corporations Act are paid the remuneration determined by ordinary resolution of shareholders.⁴ However, listed companies usually make alternative arrangements in their constitutions for determining the remuneration of directors.

The usual arrangement is for the board of directors to be given the power to settle the remuneration arrangements for executive directors, as well as for other key management personnel. Remuneration arrangements for non-executive directors are usually set out in the company's constitution or are left to the board to determine. Typically they comprise fees and other benefits to reflect the time commitment and specific board responsibilities of these part-time directors. It is not the usual practice for non-executive directors to participate in incentive-based remuneration schemes designed for executive directors and other managerial personnel. Non-executive directors have stewardship and oversight roles, not responsibility for driving the company's day-to-day performance.

⁴ s 202A(1). Section 135 explains the operation of the replaceable rules. Subsection 135(2) provides that a replaceable rule can be displaced or modified by the company's constitution.

Directors have statutory and common law duties of care and diligence and to act in good faith in the best interests of the company.⁵ These duties apply to all their conduct as directors, including the determination of remuneration arrangements.

Remuneration provided by a public company to a director is a 'related party' transaction.⁶ It is prohibited unless it is 'reasonable' or is approved by shareholders.⁷ What constitutes reasonable remuneration is determined by reference to the circumstances of the company and the responsibilities involved in the office.⁸ There has been no judicial determination of this reasonableness concept,⁹ though the ASX Corporate Governance Council has provided some guidance.¹⁰ It is not unusual for companies to obtain advice from external consultants to assist them in determining what is 'reasonable' remuneration.

Shareholders numbering at least 100 members or collectively holding at least 5% of the votes that can be cast at a general meeting can, at any time, obtain information about the remuneration paid to directors.¹¹

Public companies must provide shareholders with a remuneration report 'in a separate and clearly identified' section of the annual report.¹² Shareholders must be given a reasonable opportunity at the annual general meeting to ask questions about, or make comments

⁵ ss 180-181.

⁶ ss 228-229.

⁷ ss 208, 211.

⁸ s 211(1)(b).

⁹ The forerunner of s 211 (s 243K) was discussed in *Forge v ASIC* [2004] NSWCA 448 at [299]-[300], but without the need to determine what constitutes reasonable executive remuneration. See also *Dome Resources NL v Silver* [2008] NSWCA 322, which deals with retirement benefits of directors. The view in RP Austin, HAJ Ford and IM Ramsay, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis 2005) at 15.19 is that:

The standard of what is 'reasonable' may vary from industry to industry and may depend on the nature and position of the company.

¹⁰ The ASX Corporate Governance Council *Principles and Recommendations* Commentary on Recommendation 8.3 recommends that, given s 211, companies submit to shareholders any proposed new issue of equity to directors under remuneration incentive plans prior to implementation, thereby 'providing the board with a timely assurance that a plan is reasonable'.

¹¹ s 202B.

¹² s 300A(1).

on, the remuneration report.¹³ A resolution that the remuneration report be adopted must be put to the vote at the annual general meeting.¹⁴ Shareholders can pass a non-binding vote for or against the report.¹⁵

Termination benefits for company directors, senior executives and other key management personnel that exceed one year's average base salary are subject to shareholder approval.¹⁶ Prior to these amendments in 2009, the threshold for shareholder approval of termination benefits was seven years total compensation.

In relation to change of control transactions, a takeover bid cannot lawfully include a condition that depends on approval of compensation to an officer or employee of the target (or any related body corporate of the target) in connection with the loss of, or retirement from, office in consequence of the bid.¹⁷ Also, the court may void agreements between a target company and its directors to give them termination benefits linked to a successful takeover bid for the company ('golden parachutes') except where the benefits have been approved by ordinary resolution of shareholders.¹⁸ There are also ASX Listing Rule controls on 'golden parachutes' (see Section 2.2.2).

Proposed amendments

In April 2010, the Government, in its response to recommendations in the PC report, indicated that it would introduce various changes to the executive remuneration framework.¹⁹

In December 2010, the Parliamentary Secretary to the Treasurer released a discussion paper *The clawback of executive remuneration where financial statements are materially misstated*. The discussion

¹³ s 250SA.

¹⁴ s 250R(2).

¹⁵ s 250R(3): 'The vote on the resolution is advisory only and does not bind the directors or the company.'

¹⁶ Part 2D.2 Div 2. The purpose and intended operation of these provisions are set out in the Explanatory Memorandum to the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

¹⁷ s 628.

¹⁸ s 1325C.

¹⁹ *Australian Government Response To the Productivity Commission's Inquiry on Executive Remuneration in Australia* (April 2010), pp 5-7.

paper sought comments on whether a clawback requirement should be introduced in Australia and, if so, how it should be implemented. Currently, it is a matter for the discretion of each company whether to have clawback provisions allowing a company to adjust remuneration outcomes (for instance, reducing unvested incentive awards) in light of factors that may not have been apparent when executive incentives were determined.

Following a period for response to an exposure draft Bill released in December 2010, the Government in February 2011 introduced into Parliament the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*. The Bill formalises part of the Government's response to the Productivity Commission report.

Proposals in the Bill affecting remuneration arrangements include:

- controls on the use of remuneration consultants, including that they must be approved by, and provide their advice directly to, the board or its remuneration committee, and must provide a declaration of independence from the key management personnel to which any recommendation relates²⁰
- a prohibition on key management personnel hedging remuneration that depends on the satisfaction of a performance condition. Hedging an equity incentive component of a remuneration package allows an executive to remove or reduce the financial risk arising from any decline in the value of that equity.²¹

2.2.2 ASX Listing Rules

Under the ASX Listing Rules, shareholder consent is required for the issue by a company of securities to be given to directors under an

²⁰ Proposed Part 2D.8.

²¹ Proposed Part 2D.7.

employee incentive scheme.²² Shareholder approval is not required for grants to directors of shares in the company purchased on-market. The approval of shareholders at a general meeting is also required for any increase in the total amount of fees payable to non-executive directors.²³

The Listing Rules, in effect, prohibit senior executives from receiving termination benefits stemming from a change of control of the company ('golden parachutes').²⁴ Also, and in addition to the statutory controls over termination payments introduced in 2009, the listing rules impose a limit on the total amount that companies can pay as termination benefits to officers (no more than 5% of the value of the company's equity interests) without the approval of shareholders.²⁵

Under the continuous disclosure requirements, a listed company announcing the appointment of a new CEO is expected to disclose a summary of the key terms and conditions of the relevant employment contract.²⁶

From July 2011, S&P/ASX 300 Index entities will be required to have a remuneration committee, comprised solely of non-executive directors, to advise the full board on matters pertaining to the remuneration of their directors and other 'key management personnel'.

2.2.3 APRA

APRA has responsibility for the prudential regulation of banks and other financial institutions in Australia.

²² ASX Listing Rule 10.14. Approval is usually sought for each annual grant (under Listing Rule 10.15), but can be sought for grants over a maximum three year period (under Listing Rule 10.15A). Share issues under employee share schemes that have been approved by shareholders are not counted for the purpose of the 15% cap for equity dilution from all company activities without shareholder approval: Listing Rules 7.1 and 7.2 (Exception 9).

²³ Listing Rule 10.17.

²⁴ Listing Rule 10.18 provides that: 'An entity must ensure that no officer of the entity or of any of its child entities will be entitled to termination benefits (or any increase in them) if a change occurs in the shareholding or control of the listed entity or child entity.'

²⁵ Listing Rule 10.19.

²⁶ Listing Rule 3.1; ASX Companies Update 1 May 2003 *Continuous disclosure and chief executive officer remuneration*.

The APRA *Prudential Standards GPS 510, APS 510 and LPS 510*, as well as the *Prudential Practice Guide PPG 511*, require regulated financial institutions to have a board remuneration committee and a formal written remuneration policy approved by the board. They also provide detailed direction and guidance on the structure and functioning of the committee and the matters to be covered by the remuneration policy. These institutions must provide their remuneration policy to APRA on request,²⁷ and must also attest their compliance with the APRA remuneration governance standards in a ‘risk management declaration’ to be submitted annually to APRA.²⁸

APRA’s remuneration requirements and guidance relate to managing or limiting the risk incentives associated with remuneration. They:

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.²⁹

The APRA requirements are closely aligned with international approaches, in particular, the Financial Stability Board’s *Principles for Sound Compensation Practices* (April 2009) and its *Principles for Sound Compensation Practices—Implementation Standards* (September 2009) (see Section 2.2.6). For instance, Australian financial institutions, like similar institutions in other jurisdictions, are required to include clawback policies in their remuneration framework for unvested incentives.

The APRA documentation is summarised in Chapter 5 of the CAMAC *Executive Remuneration Information Paper* (2010).

2.2.4 ASX Corporate Governance Council guidance

The ASX Corporate Governance Council, through Principle 8 (Remunerate fairly and responsibly) of its *Principles and Recommendations* and the accompanying commentary, provides general non-binding guidance for listed entities on the remuneration-setting process (through an ‘if not, why not’ reporting

²⁷ GPS 510 para 47, APS 510 para 46, LPS 510 para 43.

²⁸ PPG 511 para 4.

²⁹ PPG 511 para 2.

requirement).³⁰ Principle 8 deals separately with remuneration arrangements for executive and non-executive directors.

This guidance is set out in Chapter 4 of the CAMAC *Executive Remuneration Information Paper* (2010).

2.2.5 Private sector guidance

Various industry and other bodies provide guidance to boards and remuneration committees of listed entities on ‘good practice’ remuneration arrangements. They include:

- AICD³¹
- Investment and Financial Services Association³²
- Australian Council of Superannuation Investors³³
- Australian Shareholders’ Association³⁴
- BlackRock.³⁵

Private sector guidance, though lacking a formal enforcement mechanism, may nevertheless be influential. For instance, some private sector bodies that publish guidance advise or represent various institutional shareholders. Listed companies that adopt remuneration policies or practices different from the guidance offered may be at risk of having their arrangements queried, or rejected, by these shareholders.

³⁰ Listing Rule 4.10.3 requires listed entities either to comply with the recommendations in the ASX Corporate Governance *Principles and Recommendations* or, if not, to explain why they have not complied: ‘If the entity has not followed all of the recommendations the entity must identify those recommendations that have not been followed and give reasons for not following them.’

³¹ See CAMAC *Executive Remuneration Information Paper* (2010) Section 6.1.

³² id, Section 6.2.

³³ id, Section 6.3. It is expected that revised guidelines will be published in mid-2011.

³⁴ id, Section 6.4.

³⁵ The activities of BlackRock include advisory services to institutional, intermediary and individual investors. See BlackRock Corporate Governance and Proxy Voting Guidelines—Australia—2011.

2.2.6 Overseas approaches

Until recently, the general approach in overseas jurisdictions has been for statutory authorities, as well as private sector bodies, to provide non-binding guidance on remuneration arrangements, with the regulatory focus being on remuneration reporting.

Various remuneration-setting regulatory controls have now been introduced in consequence of international instability in equity and financial markets over recent years (known as the global financial crisis). The bulk of initiatives are directed at remuneration arrangements within banks and other financial sector institutions.

International

Companies generally

The Organisation of Economic Co-operation and Development (OECD) report *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009) examined a range of corporate governance practices for public companies generally in light of the global financial instability. The report saw the structure of remuneration schemes for key corporate personnel, including the incentive arrangements employed, as a key aspect of corporate governance.

A follow-up OECD publication in February 2010 sought to provide further guidance to boards on the matters contained in the OECD June 2009 report.³⁶

Financial sector entities

In April 2009, the Financial Stability Board (FSB)³⁷ published its *Principles for Sound Compensation Practices*, aimed at ensuring effective governance of remuneration practices for executives and other employees of banks and other financial institutions, including alignment of remuneration with prudent risk-taking, effective supervisory oversight and stakeholder engagement. The Principles aimed to redress deficiencies in remuneration practices in the

³⁶ OECD *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles* (February 2010).

³⁷ The Financial Stability Board was established by the G20 in April 2009, as the successor to the Financial Stability Forum, which was established in 1999 by the G7 Finance Ministers and Central Bank Governors.

financial sector in various jurisdictions that were seen as having contributed to the global financial crisis.

In September 2009, the FSB released a set of *Implementation Standards* designed to support implementation of its Principles.³⁸

In January 2010, the Basel Committee on Banking Supervision³⁹ published a methodology to guide prudential supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles and Implementation Standards.⁴⁰ In October 2010, the Basel Committee released *Principles for enhancing corporate governance*, which includes some high-level principles on remuneration practices.⁴¹ Also in October 2010, the Basel Committee released a consultative document on methodologies to adjust remuneration to risk and performance.⁴²

In December 2010, the Basel Committee issued for consultation *Pillar 3 disclosure requirements for remuneration*. The stated purpose of these requirements, developed in consultation with the FSB, is to support effective market discipline by allowing market participants to assess the quality of a bank's compensation practices and the incentives for risk-taking that may be involved. The Pillar 3 requirements add greater specificity to the remuneration disclosure guidance that was included in the Pillar 2 guidance issued by the Committee in July 2009. The proposals cover the main components of sound remuneration practices and take full account of the FSB's *Principles for Sound Compensation Practices* and the related *Implementation Standards*.

Europe

In consequence of recent regulatory and other initiatives by the European Union, and within EU Member States, a series of

³⁸ *Principles for Sound Compensation Practice—Implementation Standards*.

³⁹ The Basel Committee on Banking Supervision provides a forum for regular cooperation internationally on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally for banking institutions. The Committee comprises representatives from many countries, including Australia.

⁴⁰ *Compensation Principles and Standards Assessment Methodology*.

⁴¹ Principles 10 and 11.

⁴² *Range of Methodologies for Risk and Performance Alignment of Remuneration*.

prescriptive controls and other guidance directed principally at remuneration practices of European banks and other EU financial sector bodies have been implemented. The aim was to ensure that remuneration policies and practices by these entities are consistent with their organizational structure and promote sound and effective risk management.⁴³

The controls on bonuses, for instance, seek to overcome what were perceived to be the undue incentives some bonus arrangements created for individuals in the European finance sector to engage in short-term risk-taking on behalf of their firms, irrespective of longer-term outcomes for those entities, the market or the economy generally. The controls include:

- caps on bonuses relative to salary
- restrictions on guaranteed bonuses
- requirements to pay a proportion of bonuses in shares or contingent capital
- obligations to defer a proportion of bonuses.⁴⁴

There are also enhanced enforcement powers. For instance, the UK Financial Services Authority (FSA) has been given the power to restrain remuneration practices in the financial sector that are in breach of certain FSA *Remuneration Code* provisions.⁴⁵

⁴³ See rules enacted by the European Parliament in July 2010, FSA Policy Statement 10/20 *Revising the Remuneration Code* (December 2010), EU Capital Requirements Directive (CRD III) and the Committee of European Banking Supervisors (CEBS) *Guidelines on Remuneration Policies and Practices* (December 2010). In January 2011, CEBS was renamed the European Banking Authority (EBA).

⁴⁴ In essence, the controls are intended to end the practice that was common before the banking crisis of recent years that bankers received all their annual bonus in cash. Instead, at least 40% of a bonus must be deferred for at least three years, although this rises to 60% in some cases. Also, at least 50% of any bonus must be paid in shares or other non-cash instruments. No guaranteed bonuses of more than one year can be paid and only then in exceptional circumstances for persons in their first year of service.

⁴⁵ UK *Financial Services Act 2010* s 6, which inserted s 139A into the *Financial Services and Markets Act 2000*.

There are no equivalent prescriptive controls on bonuses or other payments in the APRA *Prudential Standards* or *Prudential Practice Guide*.

United States

The *American Recovery and Reinvestment Act of 2009* placed restrictions on the amount and form of compensation that could be paid to executives of entities receiving governmental financial assistance under the Troubled Asset Relief Program (TARP). Companies receiving TARP funds that have not yet been repaid are obliged to eliminate remuneration incentives that may generate ‘unnecessary and excessive risks’ and to tie remuneration incentives to longer-term corporate performance.⁴⁶

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* covers a broad range of matters concerning the US financial services industry, including remuneration practices. One key remuneration measure (already reflected in Australian law) is the introduction of a non-binding (‘advisory’) vote by shareholders (in the US at least every 3 years) on the company’s executive compensation arrangements (‘say-on-pay’).⁴⁷ Other matters in the US legislation that are already covered, or are foreshadowed, in Australian legislation or the Listing Rules include:

- independence of board remuneration committees⁴⁸
- disclosure requirements concerning remuneration advisers⁴⁹
- clawback provisions for erroneously awarded remuneration.⁵⁰

⁴⁶ The US Securities and Exchange Commission (SEC) has adopted rules requiring public companies with outstanding obligations under the TARP program to provide for a shareholder vote on executive pay.

⁴⁷ s 951. In January 2011, the US Securities and Exchange Commission adopted rules concerning shareholder approval of executive compensation arrangements.

⁴⁸ s 952.

⁴⁹ s 952.

⁵⁰ s 954. The Australian Government has published a discussion paper on this matter, *The clawback of executive remuneration where financial statements are materially misstated* (December 2010).

There are, however, some differences of approach between the US Act and Australian regulation. For instance:

- the US Act provides for a non-binding shareholder vote on ‘golden parachute’ remuneration⁵¹ whereas this form of compensation for a change in corporate control is more closely regulated in Australia under the Corporations Act⁵² and the ASX Listing Rules⁵³
- the US Act requires only that equity hedging arrangements be disclosed,⁵⁴ whereas hedging will be prohibited in Australia⁵⁵
- there is no equivalent in Australian law of the requirement in the US Act to measure the CEO salary against the median salary of corporate employees (‘pay parity disclosure’)⁵⁶
- the US Act has no equivalent of the requirement for shareholder approval of termination benefits in excess of one year’s salary.

The US Act does not place direct controls on bonus arrangements, as in the EU. However, the US Act requires US regulators to issue rules prohibiting payments by ‘covered financial institutions’ under any incentive compensation arrangements that either provide ‘excessive compensation’ or encourage inappropriate risks that could lead to a material loss to the institution.⁵⁷

2.3 CAMAC consideration

2.3.1 Overview

The performance of executive directors, chief executive officers and chief financial officers, and other senior managerial personnel of a

⁵¹ s 951.

⁵² s 1325C.

⁵³ ASX Listing Rule 10.18.

⁵⁴ s 955.

⁵⁵ Proposed Part 2D.7 in the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*.

⁵⁶ s 953.

⁵⁷ s 956. Various US Federal regulatory agencies have issued joint proposed rules pursuant to this provision. See, for instance the commentary in ‘Incentive Compensation Under the Dodd-Frank Regulatory Spotlight *Dechert OnPoint* April 2011/Special Alert.

listed company, has a direct and often decisive bearing on the ongoing viability and prosperity of the company. The selection of suitable executive personnel, and the alignment of their remuneration arrangements with the broader interests of the company and its shareholders, can be central to the future of the company.

In principle, remuneration arrangements for senior corporate officers should promote the interests of the company and its shareholders. The level of complexity in remuneration structures necessary to achieve these goals will vary between companies. Not all remuneration arrangements need be complex, though incentive arrangements, if employed, may inevitably be more complicated for larger companies than for smaller ones. Likewise, use of remuneration structures that are linked to a company's performance may require complex criteria to measure that performance.

A company can choose, by accepting the replaceable rules in the Corporations Act, to have the remuneration arrangements for directors determined by the shareholders. In practice, responsibility for settling the remuneration arrangements for executive directors and other senior managers of listed entities is given to boards. Boards are best placed to exercise this responsibility and be answerable through the reporting and shareholder voting process. Apart from the direction given by APRA to banks and other financial institutions, the emphasis for listed entities generally should remain on the application of appropriate corporate governance principles, with boards drawing on the considerable guidance available to assist them in this process. Any move to impose greater external controls by mandating or restricting the structure of executive remuneration incentive or other arrangements, for all or some listed companies, could create inflexibility or unintended consequences that may be harmful to the interests of these entities and their shareholders.

Directors are under statutory and common law duties of care and diligence and to act in good faith in the best interests of the company. These obligations apply to everything they do in the performance of their role, including settling the terms and quantum of executive remuneration. Additional due diligence or other legislative requirements specifically directed at executive remuneration arrangements are not warranted.

The consensus view of respondents was that remuneration-setting arrangements should remain a matter for boards, with review by shareholders. Respondents came from a cross-section of the commercial community, being industry bodies,⁵⁸ professional firms and representative bodies,⁵⁹ shareholder interests/proxy advisers,⁶⁰ remuneration consultants,⁶¹ corporate entities⁶² and commentators.⁶³ A similar non-interventionist view was expressed in the PC report.⁶⁴

While further regulatory controls on remuneration design may not be appropriate, there is no room for boards to be complacent about how they structure their executive remuneration. Well-designed remuneration arrangements can have a decisive positive influence on the immediate performance of a company and its longer-term prospects, just as poorly or inappropriately designed arrangements can damage the reputation or financial viability of a company, adversely affecting shareholders, employees, creditors and others having dealings with it.

Considerable guidance from regulatory and private sector bodies in designing remuneration packages is readily available. Submissions recognised the beneficial role of non-binding guidance and supported the continuing development of remuneration ‘good practice’, including by the ASX Corporate Governance Council in its *Principles and Recommendations*.⁶⁵

Shareholders have the right to question directors, formally or informally, on the purpose and outcome of their remuneration policies and structures, and to exercise their voting rights in response to the remuneration report at annual general meetings. Through these processes, institutional and other shareholders can have a ‘say on

⁵⁸ CSA, AICD, BCA, ABA.

⁵⁹ Ernst & Young, Freehills, Law Council of Australia, KPMG.

⁶⁰ ASA, UniSuper Management, ACSI, ISS Governance Services.

⁶¹ Guerdon Associates, Maxumise Consulting.

⁶² Macquarie Group Limited, BHP Billiton, Origin Energy.

⁶³ Kym Sheehan.

⁶⁴ at XXVII and 357.

⁶⁵ For instance ACSI was of the view that:

If it is thought that the ‘remuneration setting framework’ should provide more guidance on remuneration practices, outside of prescriptive legal requirements, ACSI suggests that guidance and ‘if not, why not’ recommendations could be produced by the ASX Corporate Governance Council to indicate what is considered ‘good practice’.

pay', both on past practices and on the future approach of the company to these matters. As summed up by one respondent:

Previously, executive remuneration matters were the sole domain of the board and an operational matter that was delegated by shareholders to the board. Disclosure and the non-binding vote on remuneration reports have, to an extent, opened a window on this complexity but do not make the process simpler. Nor will any regulation. But there has been improvement as a result of disclosure, and the engagement of boards with investors and their agents. The process is evolving and dynamic.⁶⁶

2.3.2 Limits to simplification

Designing suitable executive remuneration arrangements requires consideration by boards and their remuneration committees of a wide range of factors, such as the strategic objectives of the company, the key drivers of its performance, its corporate culture, the risks and challenges that it faces, the necessary experience, skills and responsibilities expected of its senior management team and the marketplace for executive recruitment. Boards need to retain flexibility to tailor remuneration arrangements to take account of these factors in meeting the needs of the company and attracting and retaining suitable executives. Directors also need to be mindful of the right of shareholders to receive a proper explanation of the structure and effect of remuneration packages before being asked to vote on the remuneration report. Possible refinements to the legislative requirements on remuneration reporting to assist companies in achieving this goal are discussed in Chapter 3.

Well-designed remuneration arrangements, including the extent of use of incentive or other components, may need to differ in their degree of complexity, depending on the circumstances. Legislative attempts to simplify any incentive components of executive remuneration arrangements, no matter how well-intentioned, may hinder rather than assist this process.

Respondents also expressed concern about imposing constraints on any incentive components of executive remuneration for the purpose of simplification. For instance:

⁶⁶ Guerdon Associates.

Direct regulation around the incentive arrangements reduces the capacity for boards to design remuneration that is tailored to their industry and circumstances. It inevitably leads to a one-size-fits-all approach. Boards will become increasingly risk-averse to experimentation to find solutions that work best to align their remuneration strategy with their corporate strategy.⁶⁷

Rather, as stated in one submission:

it is critical that companies retain the ability to reward and incentivise their personnel in the way that is most appropriate for their particular circumstances.⁶⁸

Lack of single suitable structure for all companies

There is no single straightforward and uniform remuneration design that will be suitable for all listed companies, or even for all companies within an industry sector.

As one submission pointed out, given the vast range of business structures, priorities and circumstances:

It is also unlikely that ... it would be possible to gain a high level of consensus on what such a structure or approach should look like.⁶⁹

Changing needs of individual companies

Corporate remuneration structures may need to serve different goals, priorities and strategic needs at different times in a company's commercial evolution or in changing market circumstances. This may require companies to redesign or further tailor their remuneration arrangements on a regular basis to respond to new or emerging circumstances and ensure the ongoing sustainability of the enterprise.

As noted in one submission:

A company in a growth phase may have different remuneration arrangements to a well established company.⁷⁰

⁶⁷ Origin Energy.

⁶⁸ Law Council.

⁶⁹ ABA.

More generally:

As companies grow and increase in complexity in all aspects, so too do the incentive components of their executive remuneration arrangements. As the global economy is developing at a fast pace and is increasing in complexity, it would be unsuitable to simplify executive remuneration in this environment.⁷¹

Incentive-based payments in business management

Regulatory pressure towards simplification may impede the use, where the board considers it appropriate, of incentive-based remuneration, to the detriment of the company and its shareholders. As one respondent commented:

it is the experience of many organisations that over-simplified remuneration arrangements lead to poor outcomes and inequities between employees. Simple remuneration arrangements will not necessarily align executive compensation with shareholder interests.⁷²

Another respondent observed that:

There is a distinct risk that over-regulation of remuneration simply puts pressure on replacing incentive or variable pay with fixed or guaranteed pay, and pressure on replacing deferred pay with advance or up-front pay. Both trends are counter to the direction of remuneration governance.⁷³

Some companies may feel compelled to circumvent externally imposed simplification requirements, to align remuneration arrangements more with their needs. One submission referred to experience overseas:

In the United States, attempts to ‘cap’ particular elements of remuneration (whether through prohibition or adverse taxation implications) have led to a ‘squeezing of the balloon’ (i.e. payment of remuneration in some other form) and greater complexity in remuneration arrangements.⁷⁴

⁷⁰ Macquarie Group Limited.

⁷¹ KPMG.

⁷² KPMG.

⁷³ Origin Energy.

⁷⁴ AICD.

2.3.3 Role of boards

The board, with its knowledge of the business of the company and its financial and operational circumstances, has the responsibility to ensure that remuneration structures are, and remain, appropriate for the company's needs and are aimed at driving superior executive performance.

Each enterprise has its own complexities, risks and challenges that a board and its remuneration committee need to consider in devising the elements of remuneration packages, including whether there should be short-term and/or longer-term incentive components, and for whom. These arrangements may need to be individually tailored, with differing degrees of complexity, depending on the responsibilities of the executives involved, the objectives and priorities of the company and its current and anticipated commercial circumstances.

Respondents also emphasised the need to give proper regard to the key role that boards and their remuneration committees should play in determining executive remuneration, including in determining whether, or in what manner, to align remuneration with individual and corporate performance measures that are appropriate to the particular circumstances of each company. For instance:

Simplifying the incentive components of executive remuneration arrangements through the 'legislative architecture' is difficult without imposing prescriptive requirements. ACSI believes that company boards are best placed to create remuneration structures which may be simple or complex depending on the objectives of the company. ACSI is therefore opposed to the introduction of prescriptive legal or regulatory arrangements aimed at simplifying the components of executive remuneration.⁷⁵

While boards should continue to have the responsibility for implementing suitable remuneration schemes, they should equally continue to be accountable to shareholders for those decisions. They should clearly explain their remuneration framework and strategy, and identify any unintended outcomes. As one respondent commented:

⁷⁵ ACSI.

boards should make every effort to explain their remuneration decisions, and any anomalies that may arise in relation to payments, particularly when it may not be readily apparent as to why such anomalies exist.⁷⁶

Also, as another respondent pointed out:

Boards and companies will be judged by shareholders as to the appropriateness of the remuneration arrangements they put in place, including the extent to which there is unwarranted complexity. In other words, the market has the capacity to discipline boards (e.g. voting on remuneration report, director re-election process) and companies (e.g. share price impact) where there is too much complexity.⁷⁷

2.3.4 Board processes

Remuneration committees

There is already considerable guidance on the composition and role of board remuneration committees.

The ASX Corporate Governance Council *Principles and Recommendations* recommend that boards of listed entities establish board remuneration committees, for the purpose of ‘focusing the company on appropriate remuneration policies’, though also noting that:

Ultimate responsibility for a company’s remuneration policy rests with the full board, whether or not a separate remuneration committee exists.⁷⁸

The ASX Corporate Governance Council places importance on structural arrangements within remuneration committees. Particular attention is given to the proportion of independent or non-executive directors on remuneration committees. Since January 2011, the *Principles and Recommendations* have included a recommendation that a remuneration committee consist of a majority of independent directors, be chaired by an independent chair and have at least three

⁷⁶ CSA.

⁷⁷ AICD.

⁷⁸ ASX Corporate Governance Council *Principles and Recommendations*, Recommendation 8.1 and the accompanying Commentary.

members.⁷⁹ Also, the corporate governance statement in the annual report should include the names of the members of the remuneration committee and their attendance at meetings of the committee.⁸⁰

From July 2011, the ASX Listing Rules will go beyond guidance by requiring each S&P/ASX 300 Index entity to have a remuneration committee, to be comprised solely of non-executive directors.

There are various private sector sources of guidance for listed companies generally on the purpose and responsibilities of remuneration committees (see Section 2.2.5). According to one respondent:

It is the responsibility of board remuneration committees to understand the remuneration structure that is appropriate for their organisation. To achieve the necessary level of understanding, directors will seek to understand the merits of different structures that are used by other organisations.⁸¹

As indicated in Section 2.2.3, APRA has published prudential standards on executive remuneration for regulated financial institutions. The APRA documents include a discussion of the composition and role of the remuneration committee, including that:

- the committee collectively should have experience in setting remuneration and sufficient industry knowledge to allow for effective alignment of remuneration with prudent risk-taking⁸²
- the committee needs to exercise its own judgment and not rely solely on the judgment or opinions of others [such as remuneration consultants].⁸³

Behavioural factors

Alongside structural considerations, various behavioural factors can influence how well boards and their remuneration committees

⁷⁹ Recommendation 8.2. This is consistent with Recommendation 2 of the PC report. See further *Australian Government response to the Productivity Commission's Inquiry on executive remuneration in Australia* (April 2010) at 9.

⁸⁰ ASX Corporate Governance Council *Principles and Recommendations: Guide to reporting on Principle 8*.

⁸¹ KPMG.

⁸² PPG 511 para 13.

⁸³ PPG 511 para 19.

perform their responsibilities in settling suitable remuneration arrangements and monitoring executive performance against the policies and expectations underlying these arrangements. Research⁸⁴ suggests that these behavioural factors can include:

- *independence of mind*: with whom each director identifies, regardless of whether he or she is technically an independent or non-executive director⁸⁵
- *effective board processes*: the internal dynamics of the board, including the level of monitoring effort expected of directors,⁸⁶ the degree of encouragement (within limits) of open and active discussion and debate by board members,⁸⁷ and the overall level of board cohesiveness.⁸⁸

⁸⁴ See, for instance, A Capezio & J Shields, *Beyond the Myth of Board Independence* (Academy of Management Annual Congress, Montreal, August 2010) at 23 ff.

⁸⁵ id at 25:

Directors with strong identification with external stakeholders, including shareholders, customers and suppliers, are likely to be more diligent monitors than those with weak identification on this dimension. Directors with strong identification with being a CEO and low identification with other relevant identities will not be as effective as monitors.

⁸⁶ id at 27:

Effort norms, which refer to the groups' shared belief regarding the level of effort each individual [director] is expected to put toward a task can have a powerful influence on individual behaviour, such as the time a director allocates to monitoring duties.

⁸⁷ id at 27:

Cognitive conflict refers to the [board's] level of acceptance of issue-related disagreement and critical investigation, particularly over matters that are complex and ambiguous. A culture averse to cognitive conflict may well induce 'groupthink' and amplify the monitoring-averse influence of CEO identification. A culture supportive of cognitive conflict may require the CEO to explain, justify and modify their position, result in closer consideration of alternative strategies, remind executives of the board's collective power, and reduce the influence of CEO identification and positively moderate the pro-monitoring influence of shareholder identification. Beyond a point, however, conflict may damage group affinity and cooperation, impair director identification and transform monitoring into a blood sport.

⁸⁸ id at 27-28:

Board cohesiveness refers to the degree of interpersonal attraction and trust among members. Up to a point, cohesiveness is likely to promote cooperation and information sharing, enhance the influence of director and shareholder identification on monitoring and constrain the anti-monitoring influence of CEO identification.

See also the ACSI Research Paper *The State of Play on Board Evaluation in Corporate Australia and Abroad* (October 2010), which includes an outline of factors for achieving effective board performance, as well as a discussion of factors that can hinder board effectiveness.

These, sometimes critical, behavioural features in the remuneration setting and evaluation processes of the board and its remuneration committee are not amenable to regulatory prescription.

Remuneration consultants

Boards, or their remuneration committees, may choose to engage professional remuneration consultants.

A broad approach to disclosure of remuneration advisers has been adopted in the US *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*.⁸⁹ Also, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* includes various requirements where remuneration consultants are engaged.⁹⁰

One respondent proposed that remuneration consultants develop a remuneration consulting standard (similar to the industry-based voluntary Remuneration Consultants Code of Conduct in the UK) by forming a broad consultative group that includes representative bodies such as Chartered Secretaries Australia and the Australian Institute of Company Directors, as well as senior HR managers of Australia's listed companies.⁹¹

CAMAC sees merit in a private sector initiative of this nature. It would be one way to assist boards and remuneration committees to make the best use of remuneration consultants to advance the interests of the company and its shareholders.⁹²

⁸⁹ s 952.

⁹⁰ Proposed Part 2D.8.

⁹¹ Kym Sheehan.

⁹² Some UK research suggests that use of remuneration consultants may have a positive effect on the structure of CEO pay by encouraging incentive-based compensation: G Voulgaris, K Stathopoulos, M Walker, 'Compensation Consultants and CEO Pay: UK Evidence' (2010) 18 *Corporate Governance: An International Review* 511.

2.3.5 Designing remuneration arrangements

Good remuneration design can be a complex and dynamic process. As one respondent noted:

remuneration structures that are linked to company performance will naturally be complex given the complex nature of, and influences on, company performance.⁹³

Settling remuneration arrangements inevitably requires judgments by the board of each company on how best to reward executives fairly while motivating them to achieve performance outcomes that advance the interests of the company and its shareholders. These design decisions do not easily lend themselves to external prescription. This view was reflected in submissions, for instance:

ACSI does not believe that it should be the role of the Government or Government agencies to prescribe remuneration design requirements that could potentially impose arbitrary designs aimed at ‘simplifying incentives’ that are not suited to a company’s objectives. We note that there are a range of possibilities and configurations that will determine the design and impact of short and long term incentives. The consideration of these issues requires remuneration committees, and boards, to be mindful of the needs of the company to attract and retain executives, and to reward executives for genuine out-performance.⁹⁴

There is no single combination of remuneration elements, or ways to implement them, that is suitable for all listed companies.⁹⁵ As a

⁹³ Ernst & Young. See further Section 2.2 of that submission (The complexities of designing effective executive remuneration plans), which sets out factors that the respondent considers are key considerations for companies in designing incentive plans. It is available, under **Submissions**, on the CAMAC Website www.camac.gov.au

⁹⁴ ACSI.

⁹⁵ Relevant factors in designing remuneration arrangements can also differ between jurisdictions. See further J Hill, R Masulis, R Thomas, *Comparing CEO employment contract provisions: Differences between Australia and the US* (Vanderbilt University Law School *Law & Economics Research Paper Series Paper No. 10-23*, and University of Sydney Faculty of Law Legal Studies Research Paper Series, *Paper No. 10/81* (2010)), which indicated that significant differences between the two jurisdictions in the typical components of CEO salaries ‘could be due to systematic differences in corporate governance, share ownership patterns, corporation and securities laws, tax codes, accounting methods, or other differences across countries’ (at 42).

practical measure, for instance, boards need to consider, amongst other matters, the particular circumstances of their companies in:

- determining the use, or relative proportion, of fixed and incentive-based ('at risk') components of a remuneration package
- achieving a balance between a short-term focus (eg increasing profit in a particular year) and a long-term focus (eg maintaining sustainable earnings) in the 'at risk' components
- settling any equity-based components
- designing any performance measures
- deciding whether some compensation should be deferred.

Ratio of fixed and 'at risk' components

It is a matter for each company to determine the components of remuneration arrangements, and how to apply them to each of their key management personnel. For instance, a company may consider that fixed income components ('base pay') may help attract suitable executives by ensuring that this remuneration can meet their reasonable financial commitments. A company may also consider that 'at risk' performance-based components may create incentives for executives to strive for superior performance on behalf of the company.

Other factors may also need to be considered. For instance, in a generally depressed securities market it may be considered to be in the longer-term interests of a company and its shareholders for the board to give some protection to well-performing executives by enhancing the fixed pay components of their remuneration arrangements. On the other hand, too great a reliance on fixed or guaranteed pay in a poorly performing securities market may appear to put executives out of step with shareholders generally. These factors need to be carefully weighed by each board. This process will not necessarily be assisted by external regulation.

Balance between short-term and long-term focus

Where 'at risk' components are used in remuneration arrangements, no one combination of short-term and long-term factors will

necessarily meet the needs of all companies or the expectations of all shareholders.

For instance, a company may have different groups of shareholders, with differing interests and timeframes for investment return. They may range from investors looking to positive corporate performance over an extended period, to market participants holding shares for a short period only and focused on immediate performance.

The varying interests of different groups of shareholders may need to be considered in designing remuneration arrangements, given that all these investor groups may be adding depth and liquidity to the public market in the company's shares.

This issue was noted in the PC report:

Rapid turnover of shareholdings ... underscores the importance of measures that can align company management with increasingly diffuse and changeable shareholder interests.⁹⁶

Longer-term shareholders may be concerned about a remuneration arrangement that, in their view, places undue weight on short-term incentives (STIs) that reward executives for short-term corporate gains, irrespective of whether those gains translate into ongoing corporate value. Equally, shorter-term shareholders may consider that placing a predominant weight on longer-term incentives (LTIs) in a remuneration arrangement may do little to encourage executives to improve corporate returns in the immediate period.

Achieving a satisfactory balance between STIs and LTIs in a remuneration arrangement should be a matter for the carefully considered and bona fide judgment of each board, taking into account the particular financial and commercial circumstances of the company and its immediate needs, as well as longer term goals. Directors will be under scrutiny to explain their decisions in the remuneration report, and may also be questioned by various shareholder groups independently of the annual general meeting.

⁹⁶ at 25.

Equity-based components

Companies may decide to have part of the remuneration for all or some of their key management personnel paid in shares or options of the company. They may see this mode of remuneration as a means directly to link executive payments to the financial market performance of the company.

The need to tailor any equity-based remuneration components to the particular circumstances and needs of each company was recognised in the PC report:

there is not a simple answer to the question of what the 'right' equity-based instrument is. A remuneration structure that works well at one company might prove disastrous at another. And what works well for an individual company at one point in time might not at another. Choosing the best equity-based instrument/s therefore requires careful consideration of the company's circumstances.⁹⁷

Achieving a balance between any equity-based and other components of a remuneration package calls for the careful exercise of judgment by boards. As one respondent commented:

Non-professional shareholders often assume that pay should mirror company share price and that share price is the proper measure of management performance. This is often not the case, especially over short periods (under 2-3 years). Share price may be driven by investor sentiment to the company's sector or industry, or general economic conditions rather than the financial performance of the company in any given period. Moreover many of the objectives set by boards may reflect long-term strategies that will not be reflected in financial performance in any given period.⁹⁸

Equity-based remuneration, including through employee share incentive schemes, is commonly seen as a means to reinforce loyalty and commitment to the enterprise. There are ASX Listing Rule requirements for shareholder consent to the issue by a company of securities to directors under these schemes.⁹⁹

⁹⁷ PC report at 198.

⁹⁸ BCA.

⁹⁹ ASX Listing Rules 10.14, 10.15, 10.15A.

CAMAC considers that it is for each board to determine whether, or how best, to include equity-based remuneration in compensation packages, while also guarding against compensation outcomes driven solely by market effects.

There can also be a ‘lag effect’ between the granting of an equity-based or other incentive and its translation into a remuneration outcome. A remuneration package seen as fair and reasonable when entered into may have quite different, and possibly unforeseeable, effects if economic or market circumstances materially change within the contract period.

As with all elements of remuneration arrangements, directors remain answerable to shareholders for their decisions on these matters through the non-binding shareholder vote process and the two strikes rule.

Performance measures

It is open to each company to design performance measures for any ‘at risk’ components of its remuneration arrangements. It is often common in practice for companies to link at least some of these measures to total shareholder returns (TSR).

TSR

One recognised method, designed to link executive and shareholder interests, is to use TSR as a performance benchmark. It is a matter for the decision of each board, depending upon the particular circumstances of each company, whether or when to use this performance measure, to whom in a company it should apply, its linkages to any other performance measures, and the appropriate timeframe for measuring TSR.

Relative or absolute TSR

A further issue for a company’s board to determine is whether any TSR benchmark employed should be measured in relative or absolute terms. A relative measure compares the TSR for the company with the TSR of comparable market sector companies, whereas an absolute measure focuses on whether returns to shareholders of the company have increased or fallen in the relevant period.

As some respondents pointed out, relative and absolute TSR can have differing effects in different, or changing, market conditions:

The global financial crisis has highlighted that while a relative total shareholder return measure is seen by some investors and others to be appropriate in ‘boom’ time, this view is not necessarily maintained in ‘difficult’ times. In difficult times, it is evident that many shareholders (particularly smaller ones) prefer rewards linked to absolute total shareholder returns (i.e. where total shareholder returns fall in absolute terms so do executive rewards)—notwithstanding that an executive, when compared to his or her peers, may have demonstrated outstanding performance to stop further losses. Such conflicting or changing views make it more difficult for companies to put in place arrangements that are likely to be acceptable to all parties under changed economic circumstances.¹⁰⁰

Likewise:

as share prices have fallen, using measures such as relative total shareholder return as a performance benchmark may in fact reward volatility and market ‘catch-up’ rather than management out-performance. In contrast, in a rising market, relative total shareholder return is seen as being superior to total shareholder return, which simply rewards all for market momentum.¹⁰¹

The decision whether to adopt absolute or relative TSR as a performance measure, or some combination of them, needs to remain a matter for the judgment of each board. Also, directors will need to consider whether any chosen TSR measures need to be adjusted as commercial or economic conditions change. These are not matters that easily lend themselves to regulatory prescription.

As summed up by one respondent:

Mandating, for example, that all organisations have a long-term incentive plan that employs a TSR hurdle, or commences vesting at the median (or above the median) in order to make these arrangements simpler for shareholders to understand will simply produce a ‘sameness’ in

¹⁰⁰ AICD.

¹⁰¹ BCA.

arrangements that may not suit some companies, and will not drive the outcomes relevant for that business.¹⁰²

Non-financial performance measures

In addition to TSR or other financial performance measures that might be employed, boards may consider whether to adopt, at least for some key management personnel, performance measures related to non-financial factors, such as effective management of staff, improvement in occupational health and safety standards, adherence to corporate values and displaying acceptable corporate citizenship.¹⁰³ There is also an increasing use of customer satisfaction surveys as a performance measure.¹⁰⁴

Where non-financial factors in remuneration arrangements are adopted, boards may also need to give close thought to the means of measuring performance against non-financial outcomes, given that they can be more difficult to verify.

A clear articulation of the rationale, and effects, of non-financial performance measures may also be called for. For instance, in the absence of a clear explanation, shareholders may be concerned about the payment of bonuses based on non-financial performance measures where the company's financial position has fallen short of shareholder expectations or has even deteriorated.

Deferral of compensation

Where companies defer the payment of some remuneration, in equity or cash, their intent can be to achieve a greater alignment of executive and longer-term corporate/shareholder interests, and reduce corporate risk, by providing time to confirm the outcome according to chosen performance measures. Deferral can be used as a retention mechanism by delaying the time when earned bonuses are paid or earned equity is issued.

¹⁰² BHP Billiton.

¹⁰³ Compare APRA Prudential Practice Guide 511 para 53.

¹⁰⁴ There has been empirical research on the relationship between customer satisfaction and corporate profits. See, for instance, D O'Sullivan & J McCallig 'Does customer satisfaction influence the relationship between earnings and firm value' (2009) 20 *Marketing Letters* 337; D O'Sullivan, V O'Connell & M Hutchinson, 'Empirical evidence of the stockmarket's (mis)pricing of customer satisfaction' (2009) 26 *International Journal of Research in Marketing* 154.

The European Union has introduced mandatory deferral of a proportion of bonuses received by executives and other employees of EU-based banks and other financial institutions. This initiative was in response to particular remuneration arrangements within the banking sector in the European Union, which were seen as too heavily weighted towards short-term performance outcomes irrespective of longer-term considerations, including the impact on the continuing viability of these entities.

No comparable issue has arisen for Australian listed companies generally. There is no evidence of a general pattern of conduct within the Australia corporate sector that would call for comparable deferral controls. Each board is best placed to determine the optimal use of deferral components and deferral periods in remuneration arrangements. There is no one standard that could fairly be applied to all listed companies or even within particular industry sectors. Careful judgment is required in each case to achieve the benefits of deferral without discouraging executive effort. As one respondent pointed out:

The risk with increasing the component of variable compensation that is deferred, and concurrently extending deferral periods, is that employees do not place any value on the deferred compensation. It therefore ceases to influence their behaviour, and can also give them more incentive to negotiate a higher fixed base remuneration. This will weaken the correlation between the interests of company executives and the interests of its shareholders.¹⁰⁵

Deferral arrangements may be complemented by some form of 'clawback' to cover benefits that were paid in the expectation of performance outcomes that, as it subsequently turned out, were not achieved or involved excessive corporate risks. Currently, it is a matter for each company to determine whether to have clawback arrangements, to whom they should apply and how they should operate. However the introduction of legislative clawback provisions is currently under consideration (see Section 2.2.1 under the heading ***Proposed amendments***).

¹⁰⁵ KPMG.

Good practice guidance

Various private sector sources provide guidance to listed companies generally on designing remuneration arrangements and the role of boards and remuneration committees in this process.¹⁰⁶

Boards may choose to consider this guidance in devising incentive and other elements of remuneration arrangements that are sensitive to the financial and operational needs of their companies and drive business performance and shareholder value. Boards may also benefit from this guidance if adjusting the design of remuneration arrangements to achieve new or emerging performance outcomes and to reflect any changes in the commercial and broader economic environment in which a company is operating.

The ready availability of this guidance also negates any need for further regulatory intervention.

2.3.6 Corporate risk

In recent years, remuneration practices at executive and employee level in banks and other financial institutions, particularly in Europe and the United States, have come under close scrutiny due to the significant upheaval in global financial markets.

Much of the focus has been on remuneration arrangements within these overseas entities that may have encouraged executives and other corporate officers to place the long-term stability and viability of their entities at risk, including by undue speculation in high-risk financial market products. Evidence has also emerged of inappropriate incentive arrangements, such as bonus structures in banks linked to achieving transactions, such as commercial or retail lending, with insufficient attention being given to the longer-term funding risks that some of these transactions may involve.¹⁰⁷ Such risk-taking conduct by financial institutions also had the potential to affect the overall stability of financial markets and damage national economies.

¹⁰⁶ Refer, for instance, to the guidance provided by various private sector bodies set out in Section 2.2.5.

¹⁰⁷ See, for instance, Central Bank of Ireland *Review of Remuneration Policies and Practices in Irish Retail Banks and Building Societies* (December 2010).

As previously indicated, these concerns have led to a number of international initiatives, as well as by the EU and the USA, directed at remuneration arrangements within the financial sector.

In Australia, APRA has included considerations of corporate risk in its remuneration governance directions and guidance for regulated financial institutions. Other listed entities receive guidance through the ASX Corporate Governance Council *Principles and Recommendations* and from private sector bodies on how to take corporate risk into account in designing remuneration arrangements.

The global increase in the level of regulation of remuneration arrangements in the financial services sector, particularly with the aim of better aligning remuneration arrangements with effective risk management of finance providers, does not, of itself, point to the need for a similar regulatory response in Australia for other listed entities.

As observed in submissions:

There are risks to Australian productivity and competitiveness if ... regulatory thrusts are designed around features observed in the finance sector, and then applied to other sectors without an understanding of their different operational and strategic circumstances and requirements.¹⁰⁸

Regulatory initiatives by APRA reflect the key role of banks and other financial providers in funding entrepreneurial activities and the need to ensure the long-term sustainability of these providers. As pointed out by one respondent, the performance and stability of financial services have:

significant potential for flow-on effects to the economy. This is the case with many sectors, but arguably more so for the financial sector, given that this sector provides funding for a broad range of companies and individuals.¹⁰⁹

There is no equivalent structural economic issue applicable to listed entities generally that calls for a regulatory initiative on executive remuneration by ASIC, or some other regulator, similar to the APRA

¹⁰⁸ Origin Energy.

¹⁰⁹ Ernst & Young.

approach. However, boards and their remuneration committees still need to consider how executive remuneration arrangements relate to corporate risk and support the company's sustainability and growth. They may benefit from considering the guidance available on these matters.¹¹⁰

2.3.7 Quantum of remuneration

From time to time comments are made about the size of some executive remuneration payments. As one submission observed:

the quantum of executive pay rather than its complexity appears to be at the heart of community concerns about remuneration.¹¹¹

Another respondent commented that:

there are very different views both within the business community and outside of it, as to what amount of remuneration is reasonable.¹¹²

Payments offered to an executive can be influenced by various factors, including the market for executive talent. The level of payment eventually received will also be influenced by the effect, over differing timeframes, of the various components of a package, as previously discussed. The outcome in some circumstances can be substantial gains to the executive. Equally, in other circumstances, the result can be substantial remuneration forgone.

Market for executive talent

It is in the interests of companies, their shareholders and other involved parties to attract and retain suitably skilled and experienced senior management personnel, to motivate them, and to reward them for high performance. Boards need to have the flexibility to design their remuneration arrangements, including quantum, accordingly. In the view of one respondent:

¹¹⁰ See, for instance, the guidance provided by the various entities referred to in Section 2.2.5 and Guerdon Associates *Remuneration committee check list for rewarding sustainable long term performance* (28/09/2010).

¹¹¹ BCA.

¹¹² Kym Sheehan.

It is not in the interests of the Australian investor base or the economy as a whole for listed employers to be handicapped in attracting and retaining talent.¹¹³

For larger companies in particular, incentive components may need to be devised or moulded to respond to the global market for management services. Legislative constraints on the quantum of remuneration may make Australian companies less competitive in an international market for executive skills by reducing their ability to reward excellent performance.

It was argued in submissions that Australian business must offer attractive incentives to secure and retain executive talent and foster future corporate leaders. In that context:

Increased forces of globalisation, including the prospects of pursuing employment opportunities overseas have been increasingly relevant factors for Australian executives especially within the professional services, resources and financial sectors. In this environment, Australian companies seeking to attract and retain skilled workers must be able to offer globally competitive conditions and remuneration packages—both in terms of structure and quantum—for all executives.¹¹⁴

Assessing quantum

While it is a matter for boards to settle the details of remuneration packages, they need to be mindful that a very large quantum outcome may be difficult to justify to shareholders, who may vote against a remuneration report for that reason. Also, remuneration payments that are perceived as unduly high could damage the commercial or general reputation of the company. Directors must carefully consider how best to motivate executives, but also guard against extreme remuneration returns.

It is open to institutional and other shareholders formally or informally to express concerns about the quantum of remuneration generally or the payments to particular individuals. In assessing quantum, interested parties can access periodic survey and other

¹¹³ Origin Energy.

¹¹⁴ BCA.

information provided by private sector bodies on trends in executive pay.¹¹⁵

2.3.8 Responding to poor performance

Shareholders may be concerned if an executive continues to receive substantial remuneration, notwithstanding his or her apparent mismanagement or poor corporate leadership.

Boards need to anticipate how to protect the interests of the company and its shareholders in the event of poor executive performance. Carefully drawn executive employment contracts generally include provisions setting out the rights of each of the parties in consequence of perceived unsatisfactory performance.

Dealing with failed executives can pose sensitive commercial as well as financial issues for companies, which boards are best placed to manage. The process in removing a particular CEO or other senior executive can have implications (positive or negative) for the reputation of the company and influence the market price of its securities, at least for a period. The board may reasonably consider that it is in the longer-term interests of the company to reach a reasonable payment agreement with a departing executive, to avoid possible disputation over the circumstances of the termination. The board also needs to attract suitable replacement candidates, who may be discouraged if the circumstances of dismissal appear too harsh for the departing executive.

Boards are now constrained in what they can unilaterally offer, following the introduction in 2009 of a requirement for shareholder approval of termination payments to directors, senior executives or other key management personnel that exceed one year's average base pay salary.¹¹⁶ Previously, shareholder approval was only required for termination payments that were made to directors and that were at least seven times their annual remuneration.

¹¹⁵ For instance, ACSI commissions an annual review of CEO pay in the Top 100 Australian companies. See ACSI media release 9 September 2010 *Directors continue to cushion CEO salaries from market pressures*.

¹¹⁶ Part 2D.2 Div 2.

The terms of reference do not include a review of these provisions. However CAMAC elsewhere recommends that all payments on termination be disclosed in the remuneration report, including any payments in settlement of a potential or actual dispute over dismissal and any gratuitous or other discretionary payments (see Section 3.18.3).

2.3.9 Role of shareholders

Except for companies that have the replaceable rule for payment of directors,¹¹⁷ shareholders do not have a formal role in settling remuneration arrangements prior to the appointment of executives. The non-binding vote by shareholders and the two strikes rule apply to remuneration arrangements already entered into by a company before the annual general meeting. Shareholders do not have the power to ‘unwind’ remuneration contracts retrospectively.

Shareholders, as the owners of equity in a company, have a legitimate interest in how corporate funds are expended, including through the remuneration arrangements for directors and other senior corporate officers. It would generally be unworkable to involve shareholders in settling remuneration arrangements in advance of appointments of such personnel, or to make such arrangements subject to subsequent shareholder approval. Shareholders, however, still have the opportunity through the non-binding vote process and the foreshadowed two strikes rule, as well as by engaging with the board at other times, to influence the way a company approaches remuneration decisions.

According to one respondent:

the introduction of the non-binding vote on remuneration reports in 2005 has been conducive to fostering improved engagement between companies and shareholders on remuneration and corporate governance issues.¹¹⁸

Institutional investors in particular have the capacity to scrutinise the incentive and other aspects of remuneration arrangements and to raise matters of concern with directors:

¹¹⁷ s 202A(1).

¹¹⁸ ACSI.

remuneration provides one of the few visible proxies for shareholders to gain insight into whether boards are exercising effective control and monitoring company executives ... there is a responsibility on shareholders, in particular institutional investors, to apply scrutiny to incentive plans. This is why effective disclosure is important, and why ACSI encourages companies to engage directly with institutional investors on remuneration issues.¹¹⁹

In the view of another respondent:

any organisation should be able to demonstrate that they have considered all aspects of plan design and that there is a clear alignment to shareholder experience/value.¹²⁰

In addition to direct discussions between boards and at least some major shareholders, equity investors can use the forum provided by the advisory vote on the remuneration report to express their concerns or vote against adoption of the report. A significant negative vote on that report, particularly if it is sufficient to activate the first strike of the two strikes rule, is likely to draw the attention of the board to remuneration policies or practices that call for further explanation or review.

Through the formal voting and informal consultation processes, shareholders have the opportunity to assess the suitability of current executive remuneration arrangements and to influence the future direction and content of a company's remuneration policies and practices, including any incentive components. As summed up by one respondent:

The answer is not in regulating the contents of incentive plans, but rather in providing shareholders with the opportunity to send a clear message, which cannot be ignored, to the board that the structures are: not aligned with their interests, indecipherable or simply not working.¹²¹

The non-binding vote and the two strikes rule point to the importance of shareholders being given sufficient information in the remuneration report to form a reasonable opinion on the

¹¹⁹ ACSI.

¹²⁰ ABA.

¹²¹ ASA.

remuneration governance and policies of the company, the remuneration framework for key management personnel and the remuneration outcomes for these persons. Companies that fail clearly to explain these matters in their reports run the risk that shareholders will respond with a ‘No’ vote on the remuneration report for that reason alone.

Issues concerning the regulation of the content of the remuneration report are further discussed in Chapter 3.

2.4 Other matters raised in submissions

2.4.1 Matters involving ASIC

Remuneration arrangements that involve the use of employee share plans are subject to the disclosure and licensing provisions of the Corporations Act.

ASIC provides some exemptions from these regulatory requirements. In particular, ASIC Class Order [CO 03/184] grants relief provided the number of shares of the company to be issued under the employee share scheme will not exceed 5% of its total issued share capital.

A number of respondents encouraged ASIC to review its policies for granting relief, including to increase the 5% cap.¹²²

CAMAC notes that the 5% cap does not appear to create a problem in practice. ASIC has the power to grant exemptions on a case-by-case basis where a company seeks to issue more than 5% of its securities under an employee share scheme. ASIC must consider each application for relief on its merits. It appears that there have been few applications for relief of this nature.

2.4.2 Taxation matters

The PC report¹²³ and various respondents to the CAMAC review¹²⁴ proposed various changes to taxation laws affecting executive

¹²² Law Council, Macquarie Group Limited, Freehills, ABA.

¹²³ Recommendation 13.

remuneration, including in relation to the time at which shares subject to employee share plans are taxed.

The Government has set out its reasons for maintaining cessation of employment as the taxing point for these equity-based payments.¹²⁵

This matter involves fiscal policy issues that go beyond the terms of reference of this report and the functions of CAMAC.

¹²⁴ Ernst & Young, AICD, Macquarie Group Limited, Freehills, Guerdon Associates, ABA, BHP Billiton, Law Council, KPMG, Origin Energy.

¹²⁵ *Australian Government Response To the Productivity Commission's Inquiry on Executive Remuneration in Australia* (April 2010) at 14-15.

3 Remuneration reporting

This chapter considers the requirements for reporting the remuneration of key management personnel, including whether the legislative architecture needs to be revised to reduce the complexity of remuneration reports and more efficiently meet the needs of shareholders and companies.

3.1 The context

The directors' report for a financial year of a listed company must include a remuneration report for the company's key management personnel, to be set out in a separate and clearly identified section.¹²⁶

At a listed company's annual general meeting (AGM), a resolution that the remuneration report be adopted must be put to the vote of shareholders.¹²⁷ The vote on the resolution 'is advisory only and does not bind the directors or the company'.¹²⁸

The legislation does not stipulate criteria for shareholders to take into account in deciding how to vote. They are not limited to the matters required to be disclosed in the remuneration report, nor is their role to determine whether the report complies with the legislative disclosure requirements. Rather, the decision of particular shareholders whether to support or oppose the report can be based on a subjective assessment of any aspect of the report (or indeed any other aspect of the company's activities that they consider relevant), which may or may not include a consideration of the company's overall remuneration policies and the remuneration arrangements for its key management personnel.

Shareholders can only vote for or against the remuneration report as a whole. There is no provision for them to vote on the remuneration of each of the key management personnel, respectively. A

¹²⁶ s 300A(1).

¹²⁷ s 250R(2).

¹²⁸ s 250R(3).

shareholder may nevertheless choose to vote on the basis of one particular aspect of the report about which the shareholder feels strongly, such as the remuneration provided to one or more particular individuals.

The shareholder vote on the remuneration report will have a real, not merely advisory, effect after the introduction of the two strikes rule. Shareholders will be given the opportunity to pass a simple majority ‘spill’ resolution, vacating a company’s board and requiring the directors to stand for re-election, if, at two consecutive AGMs, the remuneration report for the relevant year receives at least 25% ‘no’ votes by shareholders.¹²⁹

Within this context, CAMAC has considered the request from the Minister to examine the existing remuneration reporting requirements in s 300A and Corp Reg 2M.3.03 (the legislative architecture) and to:

- identify areas where the legislative architecture could be revised 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.

CAMAC considered a range of approaches involving:

- redesigning the remuneration reporting requirements by replacing the existing legislative architecture with a principles-based or other simplified legislative structure (Section 3.4), or
- maintaining the existing legislative architecture, subject to introducing various specific amendments (Sections 3.5 ff).

¹²⁹ Proposed Part 2G.2 Division 9.

3.2 Current requirements

3.2.1 Legislative development

The regulation of executive remuneration reporting has gone through various stages:

- 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 identified¹³⁰
- 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 officers¹³¹
- 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.¹³² 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

¹³⁰ Schedule 5, Division 4, clause 25(2)(b) of the Corporations Law prior to 1998.

¹³¹ These amendments to the Corporations Act were introduced by the *Company Law Review Act 1998*.

¹³² 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.

members as a whole to ask questions about, or make comments on', this report,¹³³ which is subject to a non-binding shareholder vote¹³⁴

- 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 company¹³⁵
- 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 approval¹³⁶
- in February 2011, the Government introduced into Parliament the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*, dealing with various aspects of remuneration reporting and other matters related to executive remuneration.

3.2.2 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, supported by relevant accounting standards.¹³⁷

¹³³ s 250SA.

¹³⁴ s 250R.

¹³⁵ 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 3.2.5 of this report.

¹³⁶ Part 2D.2 Div 2, introduced by the *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009*.

¹³⁷ 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'.

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.¹³⁸

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.¹³⁹

3.2.3 Concept of remuneration

'Remuneration' is defined in the Corporations Act by reference to the accounting standards.¹⁴⁰ 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 non-monetary benefits (such as medical care, housing, cars and free or

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'.

¹³⁸ s 202B.

¹³⁹ HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [10.236].

¹⁴⁰ Definition of 'remuneration' in s 9.

- 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.¹⁴¹

3.2.4 Entities required to disclose remuneration

The remuneration disclosure requirements in s 300A apply to any ‘disclosing entity’ that is a company.¹⁴²

The requirements also provide specifically for consolidated entities.¹⁴³

3.2.5 Persons whose remuneration must be disclosed

The categories of persons covered by various parts of s 300A include *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’.¹⁴⁴

The *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* confines the remuneration disclosure requirements to these individuals (see Section 3.2.7).

¹⁴¹ AASB 124.9.

¹⁴² s 300A(2). ‘Disclosing entity’ is defined in s 9, which cross-refers to s 111AC.

¹⁴³ s 300A(1)(a)(ii), (ba), (c)(i) & (iii), (1B)(b), (4).

¹⁴⁴ AASB 124 *Related Party Disclosures* (December 2009, applicable by virtue of s 300A(1AAA)) at Aus 124.9.

3.2.6 Details to be disclosed

Overview

The details of remuneration, to be included in the directors' report in a separate section headed 'Remuneration report',¹⁴⁵ relate to:

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

The legislation also provides for disclosure of such other matters related to board policy as are prescribed by the regulations.¹⁴⁶ However, no such matters have been prescribed.

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*¹⁴⁷

¹⁴⁵ s 300A(1), (1A).

¹⁴⁶ s 300A(1)(f).

¹⁴⁷ s 300A(1)(a)(i).

- 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.¹⁴⁸

Composition of remuneration package

The remuneration report must disclose for each of the key management personnel:

General

- the person's name¹⁴⁹ and position in the company¹⁵⁰ and the time the position was held (if less than the whole financial year)¹⁵¹
- details of changes or retirements during the reporting period¹⁵²

Payments and benefits

- *short-term employee benefits*,¹⁵³ 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 year¹⁵⁴)

¹⁴⁸ s 300A(1)(b), (1AA), (1AB).

¹⁴⁹ Corp Reg 2M.3.03(1) Item 1.

¹⁵⁰ Corp Reg 2M.3.03(1) Item 2.

¹⁵¹ Corp Reg 2M.3.03(1) Item 3.

¹⁵² Corp Reg 2M.3.03(1) Items 4 and 5.

¹⁵³ Corp Reg 2M.3.03(1) Item 6.

¹⁵⁴ Corp Reg 2M.3.03(2).

- *post-employment benefits*,¹⁵⁵ including pension and superannuation benefits (with comparative information for the previous year¹⁵⁶)
- *other long-term employee benefits*, separately identifying any amount attributable to a long-term incentive plan¹⁵⁷ (with comparative information for the previous year¹⁵⁸)
- *termination benefits*¹⁵⁹ (with comparative information for the previous year¹⁶⁰)
- the monetary value and date of any payments made during the financial year as consideration for a person to accept a position in the company¹⁶¹
- *share-based payments*, divided into:
 - equity-settled
 - cash-settled
 - other forms (including hybrids)with the equity-settled further distinguishing between:
 - shares and units, and
 - options and rights¹⁶²(with comparative information for the previous year¹⁶³)

¹⁵⁵ Corp Reg 2M.3.03(1) Item 7.

¹⁵⁶ Corp Reg 2M.3.03(2).

¹⁵⁷ Corp Reg 2M.3.03(1) Item 8.

¹⁵⁸ Corp Reg 2M.3.03(2).

¹⁵⁹ Corp Reg 2M.3.03(1) Item 9.

¹⁶⁰ Corp Reg 2M.3.03(2).

¹⁶¹ Corp Reg 2M.3.03(1) Item 10.

¹⁶² Corp Reg 2M.3.03(1) Item 11.

¹⁶³ Corp Reg 2M.3.03(2).

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 years¹⁶⁴
- 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 periods¹⁶⁵
- 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 equity¹⁶⁶
- details of any options and rights over equity,¹⁶⁷ and equity issued on exercise of options or rights,¹⁶⁸ separately identifying each class of equity instrument.¹⁶⁹

¹⁶⁴ Corp Reg 2M.3.03(1) Item 12.

¹⁶⁵ Corp Reg 2M.3.03(1) Item 13.

¹⁶⁶ Corp Reg 2M.3.03(1) Item 14.

¹⁶⁷ Corp Reg 2M.3.03(1) Item 15.

¹⁶⁸ Corp Reg 2M.3.03(1) Item 16.

¹⁶⁹ Corp Reg 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.¹⁷⁰

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 relates¹⁷¹
- an explanation if a grant of securities as an element of remuneration is not subject to a performance condition¹⁷²
- 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 not¹⁷³

¹⁷⁰ AASB 124.17.

¹⁷¹ s 300A(1)(ba).

¹⁷² s 300A(1)(d).

¹⁷³ s 300A(1)(e)(i).

- any performance criteria used to determine the amount of a cash bonus, performance-related bonus or share-based payment.¹⁷⁴

Where securities are an element of the remuneration

The remuneration report must include:

- details of *share-based payments*
- an explanation if a grant of securities as an element of remuneration is not subject to a performance condition¹⁷⁵
- 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.¹⁷⁶ The Government has indicated a legislative amendment to 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.¹⁷⁷

Where options are an element of remuneration

The remuneration report must disclose:

- options and rights as a subcategory of *share-based payments*
- the value of options given as part of remuneration during the year, worked out:
 - at the time of grant¹⁷⁸
 - where the options have been exercised—at the time of exercise¹⁷⁹

¹⁷⁴ Corp Reg 2M.3.03(1) Item 12.

¹⁷⁵ s 300A(1)(d).

¹⁷⁶ s 300A(1)(da).

¹⁷⁷ Proposed Part 2D.7 in the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*. See also *Australian Government Response to the Productivity Commission's Inquiry on Executive Remuneration in Australia* (April 2010), p 6 (response to rec 5 of the PC report).

¹⁷⁸ s 300A(1)(e)(ii).

¹⁷⁹ s 300A(1)(e)(iii).

- where the options have lapsed because a condition was not satisfied—at the time of lapse (but assuming that the condition was satisfied)¹⁸⁰
- the percentage of the value of remuneration for the financial year that consists of options.¹⁸¹

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.¹⁸²

3.2.7 Proposed amendments

In April 2010, the Government, in its response to recommendations in the Productivity Commission report, indicated that it would introduce various changes to the executive remuneration framework.¹⁸³

In February 2011, the Government introduced into Parliament the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*. The Bill formalises part of the Government's response to the Productivity Commission report.

Key proposals in the Bill affecting the remuneration report include:

- confining the reporting requirements to the key management personnel of the disclosing entity (deleting the additional references to the parent entity and the five named executives who receive the highest remuneration for the year)
- requiring the company to disclose details relating to the use of remuneration consultants
- introducing the two strikes rule to give shareholders the opportunity to vote out a company's directors if the report receives 25% or more 'no' votes by shareholders voting on the

¹⁸⁰ s 300A(1)(e)(iv).

¹⁸¹ s 300A(1)(e)(vi).

¹⁸² s 300A(1)(e)(vii).

¹⁸³ *Australian Government Response to the Productivity Commission's Inquiry on Executive Remuneration in Australia* (April 2010), pp 6-7.

report (either in person or by proxy) at two consecutive AGMs. If these two strikes occur, the company at the second AGM must put forward a board ‘spill’ resolution, which, if supported by a simple majority of shareholder votes, will require the board to stand for re-election at a meeting to be held within 90 days.

The Bill also prohibits key management personnel from voting their shares, or undirected proxies they hold (with a limited exception for the chair of a meeting), on the remuneration report or on any ‘spill’ resolution in consequence of a two strikes ‘no’ vote.

There are also controls on proxy holders ‘cherry picking’ directed proxies and declarations by companies that there are no vacant board positions.

3.3 Purpose of the remuneration report

The remuneration report serves a key corporate governance role. It enables shareholders and others to assess the remuneration strategy of the company and the outcomes for key management personnel. Through the non-binding vote and the two strikes rule, shareholders can influence the way in which boards develop and explain their approaches on these matters.

A remuneration report should explain to shareholders how the remuneration system for key management personnel is intended to function and how it in fact functions. To achieve this, the report should cover three broad areas:

- *remuneration governance and policy*: an outline of the company’s remuneration governance framework, its remuneration policy and any link between this policy and the company’s performance and shareholder interests
- *remuneration framework*: details of how remuneration outcomes are derived
- *remuneration outcomes*: disclosure of the outcomes in the reporting period for each of the key management personnel.

In Section 3.4, CAMAC considers the merits of moving towards a new regulatory model for remuneration reporting as a means of achieving these reporting objectives. That section also considers the

alternative approach of making various adjustments within the current reporting framework.

In assessing these matters, CAMAC has adopted the principle that it is a matter for each company to choose the remuneration arrangements that it considers are the most suitable for its circumstances. Companies may differ, for instance, in their use of performance-related payments as a means of meeting their corporate objectives. The remuneration reporting requirements should focus on the disclosure of the actual arrangements entered into, not imply that some types of remuneration arrangements are preferable or should be adopted generally.

3.4 Possible regulatory approaches

3.4.1 The issues

The current requirements in s 300A and Corp Reg 2M.3.03 for the content of remuneration reports are highly prescriptive.

Arguably, any detailed legislative requirements for the content of remuneration reports may over time fall out of line with remuneration practices, which are constantly changing.

In addition, the two strikes rule may place additional pressure on companies to adjust their remuneration reports to meet investor expectations. In turn, this pressure might complicate the task of preparing remuneration reports, particularly if companies encounter tension between the legislative requirements concerning the content of these reports and investor expectations about the information to be provided.

This raises the questions set out in the reference whether, or how best, to revise the legislative architecture (s 300A and Corp Reg 2M.3.03) to:

- reduce the complexity of the legislation and more effectively meet the needs of shareholders and companies
- reduce the complexity of remuneration reports.

3.4.2 Submissions

Reducing the complexity of the legislation

Need for flexibility

A number of respondents to the CAMAC review referred to the potential impact of the two strikes rule, and the need for the legislation to provide flexibility for companies in preparing remuneration reports that meet shareholder expectations:

Given [the proposed two strikes rule] a guiding principle should be that boards should have sufficient flexibility to present their reports in the manner that allows them to best explain the way they have designed and managed remuneration arrangements and linked them to strategy.¹⁸⁴

... the introduction of the 'two strikes' rule will have a profound impact on an organisation's desire to communicate clearly with shareholders.¹⁸⁵

It was also argued that, as the two strikes rule puts the company's governance structure at stake, organizations need flexibility in how they communicate with shareholders in the remuneration report:

It is imperative that organisations be able to tell their remuneration story in a way that allows shareholders to make an informed decision.¹⁸⁶

A number of respondents proposed different approaches to reducing the complexity of the legislation to provide this flexibility and more effectively meet the needs of shareholders and companies.

Principles-based approach

AICD Position Paper No. 15 *Remuneration Reports* (June 2010) took the view that remuneration reports and the legislative requirements governing them have become unduly complex, placing a significant burden on companies, while being of limited use to shareholders and other readers.

The Position Paper proposed that the legislation take a principles-based approach to the remuneration report, in lieu of the

¹⁸⁴ Origin Energy.

¹⁸⁵ Macquarie Group Limited.

¹⁸⁶ Macquarie Group Limited.

current prescriptive requirements. This would involve an obligation on the company to provide information that shareholders ‘would reasonably require to make an informed assessment’ in each of the following areas:¹⁸⁷

- the company’s governance structures for determining the remuneration of key senior¹⁸⁸ personnel
- the company’s remuneration philosophy and policies for these persons¹⁸⁹
- the remuneration outcomes in the reporting period for each of these persons¹⁹⁰
- the entitlements to future remuneration generated in that period for each of these persons.¹⁹¹

The Position Paper identified specific matters that should be covered in the remuneration report in each of these areas, to be set out in new regulations that would replace the current regulations.¹⁹² As far as practicable, each of these areas should be discussed in a separate section of the remuneration report.

The Position Paper also proposed that the legislation should require that:

- as far as practicable, the remuneration report clearly distinguish between the remuneration arrangements, outcomes and entitlements for non-executive directors (if any) and the remuneration arrangements, outcomes and entitlements for other members of the key senior personnel¹⁹³

¹⁸⁷ AICD Position Paper rec 2.

¹⁸⁸ AICD prefers the term key senior personnel to key management personnel. See AICD Position Paper at Section 2.3. This matter of terminology is further discussed at Section 3.6.2 of this report.

¹⁸⁹ See further Section 3.7.2.

¹⁹⁰ See further Section 3.9.2.

¹⁹¹ *ibid.*

¹⁹² AICD Position Paper recs 6, 7, 8 and 9.

¹⁹³ AICD Position Paper rec 5.

- the disclosure of the company's remuneration outcomes be grouped into different types of remuneration categories, with totals for each individual.

The appendices to the Position Paper set out the proposed amendments to s 300A and Corp Reg 2M.3.03 in light of the recommendations put forward in the Paper.

Various other respondents supported the concept of a principles-based, rather than a prescriptive, approach (without necessarily endorsing the Position Paper approach).¹⁹⁴ For instance, it was pointed out that:

The variety of remuneration arrangements currently in place in Australia makes it difficult to prescribe requirements to achieve meaningful or standardised disclosure.¹⁹⁵

Simplified legislation

Another submission¹⁹⁶ put forward a proposal to rewrite s 300A and Corp Reg 2M.3.03 in a shorter, simplified form.

The new s 300A would require the remuneration report to contain:

- a plain English summary of the remuneration policies
- the remuneration outcome for each of the key management personnel
- all other information as prescribed.

The new Corp Reg 2M.3.03 would contain the details of information to be included under each of the categories referred to in the new s 300A, as follows:

- the remuneration policies would cover the company's remuneration governance framework and separate descriptions of the policies used in determining the remuneration of

¹⁹⁴ The respondents included BCA, Macquarie Group Limited and KPMG.

¹⁹⁵ BCA.

¹⁹⁶ Guerdon Associates and Allens Arthur Robinson.

non-executive directors and other key management personnel, respectively¹⁹⁷

- the remuneration outcome would cover *realisable remuneration* and *remuneration grants received*¹⁹⁸ and
- prescribed information would cover specified details concerning the content of the employment contract of each of the key management personnel, dealing principally with the duration of the contract, notice periods for termination and termination benefits provided for under the contract.

Specific amendments

Some respondents supported the focus being on particular adjustments or amendments within the current legislative architecture.

For instance, one respondent ‘[did] not consider there is a need for major changes to the remuneration disclosure regime in Australia’. Rather, ‘there is room for relatively minor modifications to existing law’ as ‘certain aspects of the formal disclosure regime provide minimal information to shareholders and should be abandoned or modified’.¹⁹⁹

Another respondent²⁰⁰ summarised its position as follows:

In summary, ACSI believes that, with the exception of short term incentive disclosures, Australia’s current legislative framework for the disclosure of executive remuneration in listed companies generally operates in a way which meets the requirements of institutional shareholders. We strongly contend that any attempts to create simplified or summary disclosures should not replace the disclosure of detail for institutional investors. We reiterate that there is scope to alter the current legislative provisions to reduce complexity and ensure remuneration reports continue to meet the needs of shareholders.

¹⁹⁷ The proposals in this submission regarding the policies used in determining the remuneration of non-executive directors and other key management personnel are set out in Section 3.7.2.

¹⁹⁸ The concepts of *realisable remuneration* and *remuneration grants received*, as used in this submission, are explained in Section 3.20.3.

¹⁹⁹ ISS.

²⁰⁰ ACSI.

While Roundtable participants supported various specific adjustments to the legislative architecture, there was no overall support for any particular one of the various general alternatives to the current legislative requirements.

Reducing the complexity of remuneration reports

Various respondents were of the view that there are limits on the extent to which any changes to the regulatory approach to remuneration reporting can reduce the complexity of some remuneration reports.

For instance, one proxy adviser commented that:

perceptions of complexity in reporting are often reflective of the complex remuneration arrangements designed by listed company boards rather than legislative reporting requirements. The financial statements of a listed company would appear complex to the average reader but few would recommend that complex financial details be removed from company reports simply to improve readability. ACSI does not support efforts to reduce complexity which would result in the removal of important detail from remuneration reports.²⁰¹

A similar view was expressed by a corporate respondent, who opposed any notion that remuneration reports should be radically reduced in scope:

Our consultation with institutional shareholders would suggest they are supportive of the richness of data reported and disclosures made.²⁰²

Another respondent observed that:

changes designed to substantially simplify remuneration disclosures are unlikely to be successful unless they materially reduce the quality and quantity of information disclosed to investors. This is unlikely to improve the ability of investors to determine whether remuneration policies and outcomes are aligned with their interests.²⁰³

²⁰¹ ACSI.

²⁰² Macquarie Group Limited.

²⁰³ ISS.

That respondent commented, however, that, while the length of remuneration reports is driven in part by the widespread use of ‘boilerplate’ disclosures:

Anecdotal evidence suggests ... that over the past two years more listed companies are seeking to take ‘ownership’ of their remuneration disclosures and are discarding templates.

It was also argued that it would not be appropriate to attempt to overcome the inevitable problems of complexity in remuneration reports by requiring separate reporting for retail and institutional investors:

While some organisations may find it helpful to produce short or concise versions of their remuneration reports, designed perhaps for retail investors, and keep the fuller versions for reference to suit institutional investors, such separation should not be mandated.²⁰⁴

Rather, as observed by another respondent, nothing in the current legislation precludes a company from including a narrative approach designed to assist retail shareholders.²⁰⁵

3.4.3 Advisory Committee position

Reducing the complexity of the legislation

The content of the remuneration report is of central importance to shareholders as well as to companies, given the current non-binding vote by shareholders on adoption of the report and the forthcoming two strikes rule.

Within this context, CAMAC has considered various options to reduce the complexity of the legislation that prescribes the content of the remuneration report.

(i) Detailed rewrite of current provisions

CAMAC notes that the current legislative framework in s 300A and Corp Reg 2M.3.03 involves a highly prescriptive series of reporting requirements. They focus on the details of particular information to be disclosed, without articulating how these elements are intended to

²⁰⁴ Origin Energy.

²⁰⁵ ACSI.

interrelate within an integrated remuneration disclosure framework based on clear policy objectives.

Prescriptive legislation of this nature can, over time, become unaligned with ongoing developments in remuneration practices as the market for executive talent and remuneration expectations changes and evolves.

There is the risk that too great a reliance on prescription may lead to a divergence between the reporting requirements and the disclosures that would most usefully inform shareholders.

CAMAC considers that a detailed review, and possible re-write, of each of the requirements in s 300A and the Regulation may not prove to be productive or useful for the reasons given below.

(ii) Replacing the current provisions

CAMAC has considered whether to recommend replacing the current legislative architecture with a principles-based or other simplified legislative remuneration reporting regime.

CAMAC considers that, while some well-developed simplification proposals have been put forward, this is not the time to undertake major changes given the introduction of the two strikes rule.

Remuneration reporting practices are ever-evolving to meet changing corporate circumstances and executive expectations. From that point of view, there is never a time when it can safely be said that the elements of effective remuneration reporting are fully settled. However, the introduction of the two strikes rule is likely to have a significant impact on how companies present information in their remuneration reports, with directors being under greater pressure to explain clearly the company's remuneration practices. Companies may also seek to revise their remuneration arrangements better to meet investor expectations. This trend may exacerbate any potential tension between the current disclosure requirements and what shareholders may reasonably expect of remuneration reports.

CAMAC considers that remuneration reporting practices are likely to change or evolve over the next few years in response to the two strikes rule. CAMAC considers that, once the rule has been in operation for a few years, it would be appropriate to draw on the evolving remuneration reporting practice as the basis for replacing

s 300A and the Regulation with a non-prescriptive approach to remuneration reporting. Such an approach to the legislative architecture should be designed to give greater flexibility to companies to prepare remuneration reports that disclose remuneration policies, frameworks and outcomes in a manner that best suits the relevant company, while at the same time providing the information that shareholders require from time to time for their understanding of the company's remuneration practices.

(iii) Specific changes

Pending developments in future years that may warrant introducing a non-prescriptive approach, CAMAC recommends, as an immediate measure, a number of possible amendments to s 300A and the Regulation that can be introduced within the general structure of the current legislative framework.

These proposed amendments are designed to respond to various perceived difficulties in effective remuneration reporting under the existing provisions. They deal with matters relevant to the three broad areas of remuneration reporting set out in Section 3.3 and are discussed in the remaining sections of this chapter as follows:

- Sections 3.5–3.8: matters affecting remuneration governance and policy
- Sections 3.9–3.19: matters affecting the remuneration framework
- Section 3.20: matters affecting remuneration outcomes.

Reducing the complexity of remuneration reports

Notwithstanding changes that might be made to the legislative architecture, there are limits on the extent to which remuneration reports can be simplified.

Some remuneration reports will inevitably be difficult to understand because of the complexity of the remuneration practices that they seek to describe.²⁰⁶

One possibility is to require separate remuneration reports for retail and institutional investors. CAMAC does not consider that such a requirement would be feasible or necessarily beneficial. Rather, CAMAC considers that it is in the interests of companies themselves to present remuneration information to retail as well as institutional shareholders as clearly as possible and in a way that enables all shareholders to cast an informed vote on the merits of the company's remuneration arrangements and outcomes.

To assist in achieving this result, and given the absence of a reporting template in the current provisions, various respondents have put forward suggestions on how to structure a remuneration report for all classes of shareholders (Appendix 2). As one of those respondents commented:

A key differentiator that can make a remuneration report comprehensible to shareholders is a clear and logical structure that makes use of headings, tables and diagrams where relevant. Such a structure must be complemented by clearly marked disclosures which provide meaningful information to shareholders on the company's remuneration approach and why this approach is appropriate, given the company's context and business strategy.²⁰⁷

CAMAC has included these suggestions as information for companies, without any determination that they necessarily constitute best practice guidelines or are the most appropriate way to structure a remuneration report in a company's particular circumstances.

²⁰⁶ Chapter 2 sets out the reasons why it is not feasible or advisable to legislate for simplified remuneration practices.

²⁰⁷ Ernst & Young.

3.5 Remuneration governance framework

3.5.1 The issue

There are no requirements in s 300A or in Corp Reg 2M.3.03 for a company to disclose details of its remuneration governance framework. However, public companies must disclose in the directors' report section of the annual report information on each director's qualifications, experience and special responsibilities, as well as the attendance of directors at board and committee meetings.²⁰⁸

From July 2011, S&P/ASX 300 Index entities will be required to have a remuneration committee, comprised solely of non-executive directors, to advise the full board on matters pertaining to the remuneration of their directors and other key management personnel.

Also, the ASX Corporate Governance Council *Principles and Recommendations* recommend that:

- the charter of the remuneration committee or a summary of the role, rights and membership requirements for that committee be disclosed on the company's website
- the names of the members of the remuneration committee and their attendance at meetings of that committee be disclosed in the annual report.²⁰⁹

Furthermore, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* requires the disclosure of details relating to the use of remuneration consultants.

An issue raised for consideration at the Roundtable was whether there should be an obligation to include further information on the remuneration governance framework in the remuneration report and, if so, what, if any, details should be prescribed.

²⁰⁸ s 300(10).

²⁰⁹ Guide to reporting on Principle 8.

Possible additional disclosure requirements concerning the remuneration committee could include all or some of the following:

- the qualifications of each member of the remuneration committee
- the experience of each member on this committee and on other similar committees
- how long the chair of the committee has served in that capacity
- any changes to the membership of the committee since the last remuneration report
- management advice to the committee
- any conflicts of interest that may have arisen and how they were managed
- a general ‘wrap up’ requirement, namely any other information that a shareholder would reasonably require to make an informed assessment of the remuneration governance framework of the company.

3.5.2 Roundtable deliberation

There was considerable opposition at the Roundtable to any requirement to include any of this additional information in the remuneration report. Points made included that:

- the qualifications of directors on the remuneration committee are already set out in the annual report. Beyond that, the disclosure requirements for members of that committee should not be any more onerous than for members of the audit or other board committees
- individuals are not appointed as directors simply on the basis of their capacity to participate on the remuneration committee. To have this extra level of detail might suggest that only experienced persons could serve on remuneration committees
- many smaller listed companies do not have a remuneration committee. To prescribe additional disclosures may discourage the formation of remuneration committees

- companies will take different views on how much information to include in any general ‘wrap up’ requirement, leading to concern about the potential width of the requirement and inconsistencies in approach between companies.

3.5.3 Advisory Committee position

CAMAC considers that s 300A should be amended to include a requirement for companies to include in the remuneration report a general description of their remuneration governance framework to the extent that it is not otherwise disclosed elsewhere in the annual report (in which case a cross-reference should be included in the remuneration report).

Taking into account the ASX requirements, the ASX Corporate Governance Council initiatives and other provisions in the Corporations Act requiring information about directors, CAMAC is not persuaded that it is necessary to mandate any details of that summary.

CAMAC notes, and agrees with, the view of participants at the Roundtable that the disclosure requirements for members of the remuneration committee of the board should not be more onerous than for members of the audit or other board committees.

CAMAC notes that conflicts of interest of directors have to be disclosed under the current law.²¹⁰ An additional disclosure requirement directed specifically at remuneration matters is not warranted.

3.6 Persons covered

3.6.1 The issues

Questions arose in submissions and at the Roundtable about the most suitable terminology for persons covered by the remuneration report and the disclosure of details of those persons.

²¹⁰ Corporations Act s 191.

3.6.2 Terminology

Currently, s 300A and the Regulations use the term ‘key management personnel’ to identify the persons to be included in the remuneration report. Subsection 300A(1AAA) provides that the term ‘key management personnel’ has the same meaning as in the accounting standards, namely:

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.

As previously indicated (Section 3.2.7), the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* limits the disclosure obligation to key management personnel, deleting the additional reference to the five named executives who receive the highest remuneration for the year.

The AICD Position Paper proposed a change of terminology to ‘key senior personnel’, arguing that the term ‘key management personnel’, which includes non-executive as well as executive directors, might suggest that all directors have a managerial role:

A director would not have a ‘managerial’ role with the company unless he or she is also a member of the executive team (for example, a CEO/Managing Director). As directors perform oversight and strategic functions for the company and are not usually involved in the day to day operations of the company, the use of the word ‘management’ to encompass both roles creates confusion.²¹¹

3.6.3 Details of persons covered

Corp Reg 2M.3.03(1) Items 1-5 require the disclosure of particular details of each of the individuals included in the remuneration report.

An issue raised for consideration at the Roundtable was whether these requirements should be expanded to require that remuneration reports contain all or some of the following additional details for each member of the key management personnel:

²¹¹ AICD Position Paper at pp 9-10, and rec 4.

- whether the person's position is full-time or part-time
- the person's length of service
- any material changes to the person's position since the previous report.

No participant at the Roundtable considered it necessary to include details about the persons covered in the remuneration report beyond those currently prescribed.

3.6.4 Advisory Committee position

Terminology

In principle, the corporate officers whose remuneration should be disclosed in the remuneration report should be the executive and non-executive directors, the chief executive officer (CEO) and all executives who report directly to the CEO.

The current concept of key management personnel appears to cover these persons, albeit using a functional rather than an organizational test.

CAMAC supports continuing to use the term key management personnel, defined by cross-reference to the definition in the accounting standards.

Details of persons covered

CAMAC is of the view that the current disclosure requirements concerning the details of key management personnel are adequate.

3.7 Remuneration policy

3.7.1 The issue

Paragraph 300A(1)(a) requires the remuneration report to contain a discussion of board remuneration policy as it affects key management personnel.

The Government supported the Productivity Commission's recommendation to include a plain English summary of remuneration policies.²¹²

A question raised in the review was whether further details on the matters to include in this discussion should be prescribed.

3.7.2 Submissions

A number of respondents put forward summaries of matters that they considered should be covered in any description of a company's remuneration policies.

For instance, AICD Position Paper No. 15 summarised matters relevant to the description of a company's remuneration philosophy and policies, including:

- a description of the company's guiding principles or approach in setting remuneration for key management personnel
- a summary of the key aspects of equity-based and other performance-based plans for these persons
- a summary of the performance conditions in place at any time during the reporting period which attach to the remuneration of key management personnel
- an explanation of the link between the remuneration of relevant executives and company performance.²¹³

One respondent²¹⁴ proposed that the following matters be included in the description of the remuneration policy for key management personnel:

- the rationale for the remuneration policy (in terms of strategy, risk profile and shareholder alignment)
- the rationale for any remuneration mix policy

²¹² *Australian Government Response to the Productivity Commission's Inquiry on Executive Remuneration in Australia* (April 2010), p 6, rec 8.

²¹³ Section 2.5.

²¹⁴ Ernst & Young.

- details and rationale for remuneration and performance benchmarking comparator groups
- details of any mechanisms to guard against extreme incentive payments from formulaic incentive plans.

Another submission²¹⁵ proposed that a discussion of the remuneration policies for key management personnel include the following matters:

- (a) a summary of the policies used in determining remuneration for key management personnel (other than non-executive directors) including where relevant:
 - (i) how fixed remuneration, short term incentives, long term incentives and other benefits are used
 - (ii) the objectives and structure of:
 - (A) fixed remuneration
 - (B) short term incentives
 - (C) long term incentives
 - (D) other benefits
 - (iii) a description of any plans or policies governing how short term incentives and long term incentives are determined
 - (iv) the extent to which the plans or policies in paragraph (a)(iii), or any other incentive pay arrangements, were subject to sensitivity analysis to determine the impact of unexpected changes
 - (v) a description of any use of comparator groups for benchmarking the remuneration of key management personnel and why these comparator groups are appropriate
 - (vi) a description of any use of constraints or caps to guard against extreme outcomes from formula based contractual obligations

²¹⁵ Guerdon Associates and Allens Arthur Robinson.

- (vii) any material changes to the remuneration policies that applied during the previous financial year
- (b) a separate summary of the policies used in determining remuneration for key management personnel that are non-executive directors including where relevant:
 - (i) the policy regarding remuneration payable for particular roles or duties undertaken by non-executive directors
 - (ii) to the extent relevant to non-executive directors, the matters described in (a)
- (c) how the company's remuneration policies are reviewed and evaluated
- (d) how the company's remuneration policies align with the risk management framework of the company.

However, it was argued in some submissions, and at the Roundtable, that detailed prescription of matters to be covered in the description of remuneration policies could be counterproductive. For instance:

mandating disclosure of 'soft' concepts such as 'policy' tends to result in companies preparing boilerplate answers that provide little insight.²¹⁶

There was also concern about including any general 'wrap up' disclosure requirement concerning remuneration policies, such as:

any other information that a shareholder would reasonably require to make an informed assessment of the remuneration philosophy and policies of the company.

The view was expressed at the Roundtable that such a general requirement could create concerns for conscientious companies that, even with the best of efforts, they may be in breach. Companies may respond by continuing to add to the remuneration report to avoid possible liability.

²¹⁶ Freehills.

3.7.3 Advisory Committee position

CAMAC recognises the importance of companies clearly explaining to shareholders the nature and purpose of their remuneration policies concerning key management personnel. The content of those policies is a matter for each company to settle.

CAMAC does not consider that detailed prescription of the matters to be included in the description of remuneration policies, going beyond the current general disclosure requirement in s 300A(1)(a), would necessarily assist shareholder understanding. However, each of the various approaches proposed by respondents for the discussion of remuneration policies may provide useful guidance, which each company could consider in the context of its particular circumstances.

3.8 Relationship between remuneration policy and corporate performance

3.8.1 The issues

As previously indicated, s 300A(1)(a) requires the remuneration report to contain a discussion of the board remuneration policy for the key management personnel. In addition, s 300A(1)(b) requires a discussion of the relationship between that policy and the company's performance. Subsections 300A(1AA) and (1AB) identify a range of matters that must be specifically dealt with in the discussion of the company's performance for the purpose of s 300A(1)(b).

Issues raised in the review concerned whether there should be further statutory elaboration on matters concerning the relationship between remuneration policy and corporate performance or, alternatively, whether all or some of the existing requirements in s 300A(1AA) and (1AB) could be dispensed with.

3.8.2 Submissions

One respondent²¹⁷ suggested incremental changes to the presentation of information under s 300A(1AA):

Shareholders would be more likely to receive a genuine reflection of performance if all reports set out the same measure of performance, in a graph, which also set out CEO total remuneration for the same period. In order to avoid the risk that by prescribing the information, the true picture might be lost in some limited circumstances, the narrative would provide an opportunity to discuss any anomalies and provide further information. The ASA would favour a graph setting out total shareholder return and CEO total remuneration over a period of five years.

However, other submissions argued that the current prescriptive approach in s 300A(1AA) and (1AB) did not necessarily improve the information to shareholders. One respondent²¹⁸ was of the view that:

- It is difficult to specify the precise disclosures that would illustrate how company performance and remuneration are aligned because of differing business strategies for different companies (and therefore differing performance measures and performance periods)
- The specificity of 300A (1AA and 1AB) encourages companies to detail earnings and shareholder returns over the required period in isolation of remuneration outcomes. In most companies' remuneration reports, this information does not increase shareholder understanding
- The requirement to disclose five year earnings and total shareholder return performance in the link between performance and reward section: This requirement is poorly defined and may not align with the performance period and measures of the company's incentive plans. If this is the case, it solely serves to lengthen disclosures in a way that is not meaningful.

²¹⁷ ASA.

²¹⁸ Ernst & Young.

That respondent proposed replacing the provision with other disclosure requirements.

Another respondent²¹⁹ supported repealing s 300A(1AA), (1AB), arguing that s 300A(1)(b) suffices for the purposes of discussing the relationship between board remuneration policy and the company's performance:

The provisions requiring the remuneration report to incorporate a specific discussion of the company's performance during the financial year should be removed as they provide little value to shareholders. Section 300A(1)(b)—which requires a discussion of the relationship between remuneration policy and performance—provides adequate statutory guidance without additional prescriptive requirements.

3.8.3 Advisory Committee position

It is a matter for each company to determine the relationship, if any, between its remuneration policy for all or any of its key management personnel and the company's performance, using performance outcome measurements of its own choosing.

CAMAC considers that it should remain obligatory for a company in its remuneration report to discuss the degree to which there is a link between its remuneration policy and corporate performance, as required by s 300A(1)(b). This discussion should state the company's reasons for not having a link if that is the case. However, the additional details required by s 300A(1AA) and (1AB) are unduly prescriptive, without adding any significant benefit. CAMAC recommends repeal of s 300A(1AA) and (1AB).

A company that fails adequately to disclose in the remuneration report its rationale for having, or not having, a remuneration-corporate performance link for all or some of its key management personnel may face the prospect of shareholders not being convinced that the remuneration arrangements are in their interests, and voting against the report for that reason.

²¹⁹ ISS.

3.9 Performance conditions

3.9.1 The issues

Where an element of remuneration to a member of the key management personnel depends on the satisfaction of a performance condition, companies are obliged under s 300A(1)(ba) to disclose:

- a detailed summary of the performance condition;
- an explanation of why the performance condition was chosen;
- a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen; and
- if the performance condition involves a comparison with factors external to the company, a summary of the factors to be used in making the comparison, including relevant comparator companies if relevant.

Issues have arisen as to the degree to which companies are disclosing any performance conditions that they have chosen to employ, whether any legislative changes are needed concerning the information on performance conditions to be disclosed and whether there should be an exemption from disclosure of any commercially sensitive information linked to performance conditions.

3.9.2 Submissions

Exemption from disclosure of performance conditions

Respondents raised a number of concerns about the level of disclosure of performance conditions in remuneration reports. One concern was that the effect of s 300A(1)(ba) may be to require companies to disclose commercially sensitive performance hurdles, such as forward-looking profit or earnings targets. On this view, a specific legislative exemption from disclosure of this type of information may be justified.

For instance, the AICD Position Paper commented that companies, while recognising ‘the importance of ensuring that performance conditions applied to remuneration are strategic and relevant to key organisational performance targets’:

are reluctant to set innovative and highly strategic performance conditions where the public disclosure of that information will reveal levers of competitive advantage to competitors.²²⁰

The Position Paper recommended an amendment to permit a company to omit from the remuneration report material about performance conditions the disclosure of which is likely to result in unreasonable prejudice to the company. Only the condition(s) likely to result in unreasonable prejudice may be omitted, as opposed to the potential remuneration benefit. If material is omitted, the report must say so.²²¹

However, one respondent²²² was critical of introducing a statutory exemption from providing information on performance conditions:

While we acknowledge the issue of commercial sensitivity, this does not appear to be an impediment for two reasons. Firstly, the reporting requirements included in ss 300A(1)(ba)(i-iii) are retrospective and the remuneration reports of listed companies reflect performance over the previous financial year. Secondly, the requirements ss 300A(1)(ba)(i-iii) do not appear to require disclosure of specific forward-looking performance hurdles or targets, or the minutiae of STI results for each senior executive. We also note that the current wording of s 300A appears to provide what the Productivity Commission defined as 'ample scope' for companies to summarise performance requirements without disclosing commercially sensitive details.

That respondent considered that companies should change the way in which they summarise performance conditions in the remuneration report:

providing an exhaustive list of performance conditions (which may or may not have a connection to STI outcomes) does not meet the needs of shareholders and contributes to 'complexity' in remuneration reports. ... Simple, retrospective disclosure of short term incentive conditions would reduce complexity in remuneration reports and improve the level of detail provided to shareholders.

²²⁰ AICD Position Paper at p 13.

²²¹ AICD Position Paper at pp 13-14 and rec 3.

²²² ACSI.

Another view was that in some circumstances an exemption from disclosure may be in the interests of shareholders:

if a Board devises a performance hurdle uniquely suitable to its circumstances and operations, and disclosure of its parameters and performance tracking would damage its competitiveness, then such disclosure would be counterproductive to shareholders' interests.²²³

It was also pointed out at the Roundtable that a company may have performance conditions tailored to particular individuals and may not wish differences in this respect between executives to be disclosed.

Information about disclosed performance conditions

Summary of the performance conditions: s 300A(1)(ba)(i)

One respondent²²⁴ drew attention to the differing approaches to the disclosure of long-term and short-term performance conditions and measures, noting:

Evidence reported in the Productivity Commission's 2009 report of a standard suite of approaches to performance measures for long-term incentives, with greater diversity of performance measures observed for short-term incentives. Observed disclosures of short-term performance measures tend to be in general terms and fail to disclose a specific link between measured performance outcomes and the incentive payments made, whereas long-term incentive payments were clearly disclosed.

Another respondent²²⁵ was critical of the current approach of companies to summarising performance conditions, pointing out that:

Shareholders are particularly interested in how the incentive plan is designed to:

- align the time horizons of executives with those of investors in the company, with the long term and short term strategies of the company

²²³ Origin Energy.

²²⁴ Kym Sheehan.

²²⁵ ASA.

- encourage sustainable long-term earnings.

Whilst remuneration reports frequently state that the various incentive plans employed are designed to achieve these ends, detailed discussion is generally absent.

That respondent considered that:

amending section 300A to require reporting entities to address these issues could both:

- focus remuneration committees, consultants and others on the shareholder focussed outcomes which plans should be designed to achieve
- allow shareholders to decide whether the company has genuinely designed any such plans with outcomes for shareholders as the primary motivation.

Another respondent²²⁶ was of the view that providing greater transparency to shareholders as to how short-term incentive (STI) performance conditions are structured would be enhanced by mandating a two-tier disclosure approach, involving:

(a) disclosure of the general nature of the components of the STI targets, and (b) to the extent that it was not prejudicial to the company, disclosure of the specific targets relating to those components.

The first tier would involve the legislation requiring disclosure of the general nature of the components of the STI targets ... Reporting against these components could be on the basis of noting that performance was above, below or on target, or unmet.

The second tier would involve the legislation requiring, to the extent that it was not prejudicial, disclosure of the specific targets relating to those components. This would provide boards with the discretion to report yet not disclose commercially sensitive material.

²²⁶ CSA.

Methods used in assessing whether performance conditions satisfied: s 300A(1)(ba)(iii)

One respondent²²⁷ advocated the removal of the requirement to include a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen:

This [provision] is often interpreted as being a requirement to explain the performance hurdles (which is in fact covered by a separate disclosure requirement), and is sometimes interpreted as explaining how the performance hurdles are actually assessed (e.g., using an external data provider to undertake the relative Total Shareholder Return assessment). The requirement to disclose how the satisfaction of performance conditions is assessed and why it is assessed in this way tends to yield inconsistent information about company process and approvals. For example, companies might specify who carries out the calculations and the specific formula used. What is more relevant is information about vesting schedules: how different levels of performance affect the quantum of the incentive payment/award.

Information about the companies with which a comparison is being made s 300A(1)(ba)(iv)(B)

Where a performance measure is comparative, the identity of any comparator company must be identified.

One submission²²⁸ argued that this requirement be retained, with more information to be provided:

The use of relative measurements can only assist shareholders when the details are transparent and appropriateness of comparators can be assessed.

Remuneration reports frequently refer to benchmarking against comparator companies in order to determine fixed remuneration, without providing any information about those comparators. Where relying upon benchmarking to justify fixed remuneration, reporting entities should identify those comparators in order for shareholders to assess whether they are appropriate.

²²⁷ Ernst & Young.

²²⁸ ASA.

3.9.3 Advisory Committee position

It is a matter for each company to decide whether, or how, to link any aspect of a remuneration arrangement to the satisfaction of performance conditions, and the nature of those conditions.

CAMAC considers that the current disclosure requirements in s 300A(1)(ba) are adequate for the purpose of shareholders gaining an understanding of any intended link between the level of remuneration of one or more of the company's key management personnel and the quality of their performance on behalf of the company. CAMAC is not persuaded of the need for greater prescription of information to be disclosed under this provision. However, some of the suggestions in the submissions, set out under ***Information about disclosed performance conditions***, may provide useful guidance for companies in helping shareholders to understand the elements and implications of the remuneration arrangements with key management personnel.

CAMAC believes that it would be appropriate to introduce a legislative exemption from disclosure of commercially sensitive information concerning a performance condition. It recommends an amendment to s 300A to permit a company to exclude from its remuneration report commercially sensitive information concerning a performance condition, provided that the information remains commercially sensitive up to the time of settlement of the report and the report discloses the fact that information of this nature has been omitted and provides a general description of the omitted information.

For example, where an executive is to receive a payment if the number of claims during the warranty period for a product is reduced below a certain number, the remuneration report would need to indicate the nature of this performance condition, but could state that the specific target number of claims and the actual number of claims have been omitted because that information is commercially sensitive.

This exemption from disclosure would remove unnecessary inhibitions on companies developing performance conditions, as they would be exempt from disclosure where, for instance, their publication could result in the company being commercially disadvantaged. The exemption would also facilitate more detailed

disclosure of performance conditions, as it would put beyond doubt that performance-related information outside the terms of the exemption must be disclosed.

A possible model for this form of carve-out is found in s 299(3), which permits the omission from an annual report of information about future operations that ‘is likely to result in unreasonable prejudice to the company’, with the requirement that ‘if material is omitted, the report must say so’.

Subject to the statutory carve-out, companies would be required to comply fully with the requirements in s 300A(1)(ba) concerning the disclosure of performance conditions.

3.10 Performance/non-performance remuneration mix

3.10.1 The issue

Companies are required by s 300A(1)(e)(i) to provide in the remuneration report an explanation of the relative proportions of those elements of a person’s remuneration that are/are not related to performance.

An issue is how companies comply with this provision and whether it should be amended.

3.10.2 Submission

One respondent argued that the requirement in s 300A(1)(e)(i):

is interpreted by companies in a range of different ways, including showing target remuneration mix, maximum remuneration mix, and actual remuneration mix (based on accounting values). Some companies describe the mix qualitatively while others list or illustrate by executive. The end result is that the disclosed information cannot be compared on a company by company basis.²²⁹

²²⁹ Ernst & Young.

That respondent also observed that the problem of interpretation is exacerbated for smaller listed companies, which may not use remuneration consultants or legal advisers when preparing the remuneration report.

To promote more consistent disclosure, the respondent recommended:

modifying the requirement to explain the relative proportion of remuneration related to performance under 300A(1)(e)(i) to specifically require disclosure of the following (as a proportion of total target remuneration):

- fixed (not related to performance)
- performance-based (split into its constituent components, for example, short and long-term incentives).

The view of the respondent was that ‘total target remuneration’ should be based on the ‘remuneration opportunity’ for target levels of performance, which should comprise:

- fixed remuneration (as at the start of the year and any amendments made during the year)
- cash incentive opportunities (target and maximum, to the extent that these are provided for), which should be split into the different plans operated by the company, clearly showing what plans relate to 12 month performance and which relate to greater than 12 month performance periods
- equity incentive opportunities (expressed as a dollar value or a percentage of fixed remuneration, with an explanation regarding how this is converted into a number of shares/rights/options), split by the plans that the company operates.

3.10.3 Advisory Committee position

CAMAC acknowledges the concerns raised by the respondent. However, the Committee is not convinced that the best response is legislative amendment, which may further complicate the reporting process and would involve greater prescription.

Rather, the approach proposed by the respondent to promote more consistent disclosure of the performance/non-performance mix of remuneration arrangements could be useful guidance for companies when considering how to provide information to shareholders on this matter.

3.11 Incentives and corporate risk

3.11.1 The issue

Depending upon its elements, a remuneration structure may lead to a company being subject to undue financial risks. For instance, a remuneration arrangement may contain incentive or other elements that, intentionally or otherwise, result in substantial windfall gains to executives at the expense of the company. A remuneration arrangement may also, in effect, encourage undue financial risk-taking by executives, for instance where they are rewarded for arranging particular types of transactions on behalf of the company, regardless of the degree of financial risk involved.

Companies have an obligation to identify in the remuneration report the relationship between board remuneration policy and the company's performance (see Section 3.8). The question is whether this should be supplemented by a requirement to identify any corporate risk associated with the performance-related or other aspects of particular remuneration arrangements.

3.11.2 Submissions

One respondent²³⁰ argued that:

Performance based remuneration comes with inherent risks. The risks which should be addressed include the risk that excessive payments could be made and that awards may vest for performance which is not able to be sustained. The remuneration report should include information about the potential risks of the particular incentive schemes employed by the company, as well as the measures taken to address/reduce those risks.

²³⁰ ASA.

Another submission²³¹ favoured legislation to require the summary of board policies on remuneration to include, where relevant, a description of:

the extent to which the plans or policies [governing how short-term or long-term incentives are determined], or any other incentive pay arrangements, were subject to sensitivity analysis to determine the impact of unexpected changes [and] a description of any use of constraints or caps to guard against extreme outcomes from formula based contractual obligations.

3.11.3 Advisory Committee position

CAMAC considers that there is an increasing level of awareness of the need for boards to assess whether particular performance incentives, or other remuneration arrangements, may unduly increase corporate risk, taking into account the company's risk profile and its level of risk tolerance.

CAMAC does not support a legislative amendment to require companies to indicate in the remuneration report how they have dealt with corporate risk. Publications of the Australian Prudential Regulation Authority have dealt with this issue for financial institutions. For listed companies generally, questions concerning the appropriate level of corporate risk, including those related to particular remuneration arrangements, are matters of corporate governance coming within the general powers and duties of directors.

3.12 Application of accounting standards

3.12.1 The issues

A significant concern for many companies is the requirement to apply accounting standards in preparing the remuneration report.

Originally, there was a requirement to include a note on the remuneration of directors in the financial statements of the annual

²³¹ Guerdon Associates and Allens Arthur Robinson draft legislation and regulations.

accounts.²³² The accounting standards and audit requirements, which applied to information prepared for these financial statements, were also applied to this remuneration information.²³³ Subsequent amendments maintained the application of the accounting standards.

Currently, Corp Reg 2M.3.03(4) requires a company to apply relevant accounting standards in complying with the obligations under Corp Reg 2M.3.03(1) to report information on remuneration for each of the key management personnel. Also, s 300A(1)(e)(ii) requires the value of options granted to be determined in accordance with applicable accounting standards.

In addition, Corp Reg 2M.3.03(5) provides that an expression that is used in the regulations and is defined in a relevant accounting standard that is applied for the purpose of disclosing information has the meaning given by that accounting standard. Currently, various relevant terms are defined in the accounting standards.²³⁴

The relevant accounting standards are AASB 124 *Related Party Transactions*, AASB 119 *Employee Benefits* and AASB 2 *Share Based Payments*.

In addition, s 308(3C) requires an auditor to state an opinion on whether a remuneration report complies with the statutory requirements.

The issues that arise concern whether to discontinue the requirement to apply the accounting methodology in the accounting standards to the content of the remuneration report and, if so, what role, if any, should be given to an external auditor.

²³² See s 297 and Schedule 5, Division 4, clause 25 (Remuneration of directors) of the Corporations Law prior to 1998.

²³³ ss 296, 298 of the Corporations Law prior to 1998.

²³⁴ Appendix A of AASB 2 contains the following definitions applicable to the 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 the interpretation of Corp Reg 2M.3.03: 'employee benefits', 'post-employment benefits', 'short-term employee benefits' and 'termination benefits'.

3.12.2 Submissions

There was a general view in submissions, and at the Roundtable, that the requirement to apply the accounting methodology in relevant accounting standards to information in the remuneration report can be confusing and misleading to shareholders. For instance:

Australian disclosures must show remuneration broken down into accounting expense categories. This categorisation does not reflect how remuneration is managed.²³⁵

It was argued that the use of accounting values in remuneration disclosure tables can lead to misleading results, as these values:

do not reflect the value earned and delivered to executives, and can therefore mislead the reader. Despite this fact, the commentary frequently quoted in the wider media focuses on these accounting values and represents these values as 'remuneration', which is mistakenly interpreted by the public as 'take home pay', which it is not. This results in misleading reporting, and adds to the public's misconceptions regarding remuneration quantum.²³⁶

Respondents were also critical of the application of accounting standards to future performance-based equity payments. For instance:

Although the accounting methodology is largely successful in enabling like with like comparisons across different organisations, it also ascribes values to share-based payments which do not relate to the actual benefits experienced by the executives (including to securities that never vest).²³⁷

Similarly:

The approach of providing accounting values of equity based remuneration can confuse shareholders who want to understand what remuneration has been actually paid to executives during the year. Remove the accounting valuations of grants of equity made during the year (but not

²³⁵ Guerdon Associates.

²³⁶ Ernst & Young.

²³⁷ BHP.

vested). This information should be made available within the financial statements.²³⁸

Likewise, the AICD Position Paper, in the context of referring to ‘theoretical measures of remuneration used for accounting purposes (for example, where performance hurdles are not yet met)’, which would include performance-based equity remuneration, commented that:

Pursuant to our proposal, theoretical accounting valuations of remuneration would be confined to the financial statements and accompanying notes.²³⁹

The Position Paper recommended that:

The company’s discussion of the current entitlements to future remuneration need not include probability-based accounting valuations of any securities or equitable instruments.²⁴⁰

The Position Paper recognised that doing away with the application of accounting standards to the remuneration report will mean that the remuneration figures disclosed in the Remuneration Report are likely to differ from those reported in the financial statements. However:

we are of the view that the resulting disclosure in the Remuneration Report will provide shareholders and other stakeholders with more meaningful information as to the actual remuneration received by key senior personnel during the reporting period and their entitlements to future remuneration.²⁴¹

Following on from this proposal to discontinue the application of the accounting standards to remuneration reports, the AICD Position Paper recommended deletion of the requirement that the company auditor provide an opinion as to whether the remuneration report complies with s 300A.²⁴²

²³⁸ ASA.

²³⁹ *Executive Summary* at p 2.

²⁴⁰ rec 9.

²⁴¹ AICD Position Paper at p 2.

²⁴² rec 11.

Other submissions were critical of the application to remuneration reports of amortisation concepts (dealing with changes to the expense borne by a company during the term of a future-vesting item of remuneration) under the accounting standards:

The amortisation of amounts across a number of accounting periods is often not simple and transparent to shareholders, and combines a portion of the value of a number of successive years' awards together—clouding the link between actual performance and remuneration outcomes. This does not assist the organisation in expressing the decisions that have led to the setting of remuneration packages for its management team during the current year, and as a result of performance over the financial period which is the focus of the rest of the annual report.²⁴³

Another respondent pointed to the problems that amortisation can generate for persons trying to assess remuneration packages:

For example, making a judgement on whether the pay for a newly appointed executive is reasonable can be difficult (or impossible), as the pay reported in the first year will show the amortised cost of, say, one third of the expected equity grant value (if a 3-year vesting period applies). Other, longer-serving, executives receiving the same annual grant value will show much higher levels of remuneration because their share-based payments reflect the amortised costs of all unvested grants over their entire service period.²⁴⁴

One submission described a benefit in discontinuing the requirements to use accounting standards:

the remuneration report will reflect 'actual pay' terms rather than theoretical accounting valuations of remuneration, which theoretical valuations currently inject ambiguity into the report and often cause confusion among shareholders and other readers of financial reports: and the directors can much more easily explain the remuneration-setting framework to shareholders.²⁴⁵

²⁴³ BHP.

²⁴⁴ Guerdon Associates.

²⁴⁵ CSA.

That respondent was also of the view that:

having different figures reported in the remuneration [report] from those reported in the financial statements will not cause confusion, given that shareholders are looking for less complex reporting on remuneration. An explanation can be provided in the financial statements of why the figures differ and the benefits this difference extends to shareholders.

There was support in submissions for the view that accounting values are useful in determining the cost to the company of remuneration arrangements, and therefore should be retained, but only in the financial statements. For instance:

Accounting costs (including those associated with share-based payments) should be disclosed only in the Notes to the Annual Financial Report and only in aggregate (i.e., for all KMP). Accounting values are useful to indicate the cost of the company's remuneration approach and are therefore more relevant as a supplement to the financial statements ... As aggregate accounting costs of KMP remuneration are already a required disclosure in the Notes to the Annual Financial Report, the requirements to disclose accounting values in the remuneration report should be removed.²⁴⁶

Other respondents supported the view that accounting standards should continue to apply to remuneration-related data, but, likewise, only in the context of the financial statements. For instance:

Accounting values of remuneration continue to be an important element in the requirements of institutional shareholders. Thus, it is Macquarie's view that this information should be included in the Financial Report of the Annual Report on an individual basis, for KMP's. This may reduce confusion for some shareholders attempting to understand complex accounting concepts, while still providing the data to those shareholders interested in the statutory values required to perform analysis on the financial statements.²⁴⁷

²⁴⁶ Ernst & Young.

²⁴⁷ Macquarie Group Limited.

Similarly:

The Directors Report and Financial Reports should be treated separately. The Directors Report should be focused on providing a simple outline of company affairs for shareholders, including remuneration, and should not be constrained by accounting standard requirements, which complicate reporting.

The Financial Reports should focus on outlining the accounts and financial information in accordance with accounting standards. If this approach is followed, the remuneration in the financial report would be audited, but there would be no need to require an audit of the Remuneration Report, also reducing compliance costs.²⁴⁸

The general view at the Roundtable was that there was still a benefit in any numbers appearing in a remuneration report being verified by an independent auditor, subject to a disclaimer that the figures had not been audited in accordance with accounting policy. Views differed on whether there should be a mandatory requirement for an auditor to verify the figures in this manner.

3.12.3 Advisory Committee position

Accounting standards

CAMAC recommends repealing the reference to the accounting standards in s 300A(1)(e)(ii) and also repealing Corp Reg 2M.3.03(4).

While accounting standards have a key role in the preparation of a company's financial statements, the application of accounting methodology in a remuneration report can be confusing and misleading to shareholders, without providing them with additional useful information.

For instance, one role of accounting methodology, as applied to a company's financial statements, is to value the cost to the company of its remuneration arrangements and allocate that cost to a particular accounting period. This differs from the focus of the

²⁴⁸ ABA.

remuneration report, which is to disclose remuneration outcomes for particular executives.

Corp Reg 2M.3.03(5), which applies various definitions in the accounting standards to the remuneration reporting requirements, should remain.

Role of the external auditor

Consistent with dispensing with the application of accounting methodology to the remuneration report, the requirement in s 308(3C) that an auditor provide an opinion as to whether the remuneration report complies with the legislative requirements should be repealed.

However, it is desirable to have an independent check on the accuracy of calculations included in a remuneration report. CAMAC recommends rewording s 308(3C) to the effect that the auditor is required to state an opinion on whether the calculations used in a remuneration report are accurate. If the auditor is not of that opinion, or is unable to form an opinion on any aspect of the calculations, the auditor's report must so indicate and state why.

3.13 Valuing future-vesting equity-based remuneration at the time of grant

3.13.1 The issues

Companies are required by accounting standard AASB 2 *Share-based Payment* to include in the annual report the estimated fair value of share-based incentive payments made to key management personnel and other employees, based on a range of accounting measures.²⁴⁹

Independently of that requirement, the question arises whether to include the value of future share-based remuneration in the remuneration report and, if so, what method of valuation to employ.

²⁴⁹ AASB 2 requires transactions in which share-based payments are made to employees to be measured by reference to the fair value of the share-based payments at grant date (AASB 2, para 11).

3.13.2 Submissions

The AICD Position Paper was of the view that there should not be any requirement to include theoretical probability-based valuations in respect of future contingent payments:

For example if a member of the key senior personnel is entitled to receive 1,000 shares in 12 months time under a performance plan (i.e. subject to meeting performance conditions) the current entitlements section of the report would disclose that the entitlement is 1,000 shares (rather than estimating the dollar value of 1,000 shares in 12 months time and the probability that the performance condition will be met).²⁵⁰

Another respondent considered that it is not beneficial to try to value future performance-based equity remuneration in the remuneration report:

The Remuneration Report could simply cease to include values for share based payments because such values rarely represent what, if anything, is ultimately received by the executive. Rather, the Remuneration Report could disclose the number of securities the entity has granted and subsequently allowed to vest for each relevant individual, and a description of the performance hurdles governing them. Investors and analysts could then form their own view of the potential value of the instruments from time to time during the performance period, without the distraction of either the accounting expense for the share-based payment which would often have its basis in the grant date value, or of the share value at vesting which would not be reflective of factors that were known at the time of the grant.²⁵¹

Another view was that including a 'fair value'²⁵² estimate of the value of equity-based future remuneration rewards in the year of

²⁵⁰ AICD Position Paper Section 2.7.

²⁵¹ KPMG.

²⁵² The Guerdon Associates and Allens Arthur Robinson submission defined 'fair value' as:

the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. In determining fair value, regard must be had to any performance conditions which must be satisfied before an asset or equity instrument will vest in the recipient, or the liability would be required to be settled, and the probability that the performance condition will be met.

grant can be of assistance to shareholders in exercising a judgment through the non-binding vote on the remuneration report. As explained in one submission,²⁵³ a ‘fair value’ method of valuation:

represents the ‘intended’ or ‘expected’ value of the equity-related interests at the time they were granted, reflecting the Board’s assessment of the performance and value contribution at the time, and also reflecting how the executive perceives the grant in terms of their remuneration package.

The ‘fair value’ approach was adopted in one of the alternative reporting models.²⁵⁴ A grant date fair value for reporting share and option remuneration has also been adopted in Canada²⁵⁵ and the United States.²⁵⁶

A concern raised in submissions was that any valuation methodology based on the grant date fair value of performance-based equity incentives can produce values that are significantly higher or lower than the actual value eventually received by the executive. For instance, this methodology:

often significantly understated executive pay during bull markets because the fair value estimates of equity incentives granted are typically significantly lower than the realised vested value of such incentives during periods of high share prices.²⁵⁷

One respondent²⁵⁸ noted, however, that:

institutional investors understand the difference between fair value estimates of share-based remuneration and the realised value of remuneration received by company executives.

The general view of participants at the Roundtable was that there is no benefit to shareholders in requiring companies to value securities during the interim period before vesting.

²⁵³ Origin Energy.

²⁵⁴ The Guerdon/Allens Arthur Robinson approach, referred to under *Simplified legislation* in Section 3.4.2.

²⁵⁵ CAMAC *Executive Remuneration Information Paper* (July 2010) at Section 9.1.2.

²⁵⁶ id at Section 9.2.1.

²⁵⁷ ISS.

²⁵⁸ ACSI.

3.13.3 Advisory Committee position

CAMAC considers that a company should be free to choose the methodology for valuing future-vesting equity-based remuneration. However, the company should be required to disclose in the remuneration report the methodology adopted and its outcome.

Accordingly, Corp Reg 2M.3.03 should be amended to require a company to disclose, in the financial year in which future-vesting equity-based remuneration was granted:

- the methodology chosen by the company to value that remuneration, and
- the number of securities granted as a result of the application of that valuation methodology.

This exercise should not be needed, or be required to be reported, in any remuneration report in the interim period before vesting.

3.14 Options

3.14.1 The issue

Specific disclosure requirements concerning options are set out in s 300A(1)(e)(ii)-(vi), as well as Corp Reg 2M.3.03(1) (Item 15) and 2M.3.03(3).

At issue is whether changes should be made to any of these requirements.

3.14.2 Submissions

Various proposals were put forward in submissions to amend or repeal these provisions.

s 300A(1)(e)(iv)

This provision requires disclosure of the value of options that were held by key management personnel and lapsed during the reporting year because a condition required for the options to vest was not satisfied.

One respondent argued that this provision:

fails to provide meaningful information for assessing pay governance.²⁵⁹

Another respondent was of the view that:

this requirement adds little value as the actual value of options that have not vested (as opposed to the fair value for accounting standard purposes) is zero.²⁶⁰

This respondent proposed that:

This section of the Act should be altered to require the number of options lapsed to be disclosed, and the grant date of the options that lapsed.²⁶¹

s 300A(1)(e)(vi)

This provision requires disclosure of the percentage of the value of each disclosed executive's remuneration that consists of share options.

One respondent considered that this provision should be removed:

Shareholders concerned over the proportion of remuneration delivered as share-based payments will be able to make an assessment based on the information already disclosed.²⁶²

Other respondents also considered that the provision was unnecessary:

The purpose of this requirement is unclear. Its inclusion does not appear to add any insights for shareholders.²⁶³

The rationale for this additional requirement and the value that it is intended to provide to shareholders is not clear.²⁶⁴

²⁵⁹ Guerdon.

²⁶⁰ ISS.

²⁶¹ ISS.

²⁶² ISS.

²⁶³ Ernst & Young.

²⁶⁴ BHP Billiton.

3.14.3 Advisory Committee position

s 300A(1)(e)(iv)

CAMAC considers that the legislation should require that the remuneration report:

- disclose any options that have lapsed in the current financial year (whether or not due to the failure of a condition), and
- indicate the year(s) in which they were granted.

There should be no obligation to include a value for the lapsed options.

CAMAC considers that these disclosures would provide shareholders with more meaningful information on lapsed options.

s 300A(1)(e)(vi)

CAMAC considers that the obligation in s 300A(1)(e)(vi) to disclose the percentage of the value of remuneration that consists of options should be repealed. It is unnecessary, as Item 15 of Corp Reg 2M.3.03 already requires disclosure of the number and value of any options that have been granted during the reporting period and the number of options that have vested during that period. The information required by s 300A(1)(e)(vi) can be deduced from the information required by Item 15 of Corp Reg 2M.3.03.

3.15 Compensation

3.15.1 The issue

Item 12(a)-(h) of Corp Reg 2M.3.03 deals with various ‘compensation’ arrangements. It requires the disclosure of various matters concerning each grant of a cash bonus, performance-related bonus or share-based payment made to any of the key management personnel.

Item 12(h) requires the disclosure of ‘estimates of the *maximum* and *minimum* possible total value’ of the bonus or grant (other than option grants) for financial years subsequent to the financial year to which the report relates.

The question is whether any change should be made to Item 12(h).

3.15.2 Submissions on Item 12(h)

A number of respondents put forward arguments for removing Item 12(h), including:

This additional requirement is often nonsensical, with the minimum potential value being nil (in the event that the employee forfeits the award or a performance hurdle is not achieved) and the maximum value being difficult to calculate (being largely dependent on future share prices of the company) to the point that its best proxy is the estimated fair value already included in remuneration.²⁶⁵

The other requirements under Item 12 of this section and under the Act itself which require disclosure of unvested outstanding equity incentives as at balance date provide sufficient information to shareholders to determine the potential rewards executives may receive in future years.²⁶⁶

The value of deferral into future periods is typically linked to a variable that has no meaningful maximum and cannot be reliably forecasted (e.g., share price). The other requirements of 2M.3.03 already provide sufficient information regarding the impact of current year grants on remuneration in future periods as they require disclosure of the vesting date and relevant vesting criteria.²⁶⁷

3.15.3 Advisory Committee position

CAMAC considers that the requirements in Item 12(h) to disclose estimates of the maximum and minimum possible total value of these types of compensation should be retained, provided that, where a value is actual and not an estimate, the report makes this fact clear.

The information in Item 12(h) concerns a key part of remuneration arrangements. Generally, it would indicate the range of remuneration that each member of the key management personnel could earn. For instance, the maximum would indicate the total amount that an executive could earn if all conditions that apply to his or her remuneration arrangements were met.

²⁶⁵ BHP Billiton.

²⁶⁶ ISS.

²⁶⁷ Ernst & Young.

Companies have the opportunity to make clear in their reports that these values, such as estimated maximums, relate to possible future events. They do not constitute actual remuneration paid to a director or other key manager, or remuneration that will necessarily be received by that person in the future.

The disclosure of maximum and minimum possible total values for a particular item of compensation need only take place in the year of grant of that remuneration item. If and when the item vests, it will appear in the remuneration report for the relevant year as crystallized past pay. However, there should be no obligation to include the item in interim remuneration reports prior to vesting of the compensation item.

3.16 Presentation of data on prior year remuneration

3.16.1 The issue

The required data on individual remuneration covered by Items 6, 7, 8, 9 and 11 of Corp Reg 2M.3.03(1) must include information on the previous, as well as the current, financial year.²⁶⁸

The question is whether there should be greater statutory direction or other guidance as to the method of presentation of this information.

3.16.2 Submissions

One respondent suggested changes to the method of presentation of this information in some remuneration reports:

Individual remuneration data for the current and prior year should be presented in the same table (some companies currently present two tables) so that the remuneration for each individual can be easily compared to the prior year. Executive remuneration (including executive directors) and non-executive director remuneration should be presented in

²⁶⁸ s 300A(1C)(b)(ii), Corp Reg 2M.3.03(2).

separate tables to simplify presentation and increase shareholder understanding.²⁶⁹

Another submission proposed a change to the method of disclosing previous year information relating to long-term employee benefits (Item 8):

Detailed descriptions of incentive plans which relate to grants made in previous years could be incorporated by reference to an easily accessed source, such [as] the company website.²⁷⁰

3.16.3 Advisory Committee position

CAMAC considers that the proposals in the submissions could provide useful guidance to companies on presenting data on prior year remuneration in a manner most useful to shareholders. However, legislative change on this matter is not warranted.

3.17 Tracking deferred remuneration

3.17.1 The issue

It is commonplace for incentive-based remuneration arrangements to include equity or other entitlements linked to future performance. It may be some years before these entitlements vest.

An issue is whether to require the remuneration report of a current financial year to include information on performance-based or other remuneration entitlements that were granted in a prior financial year but will not vest until a future financial year.

3.17.2 Submissions

One respondent²⁷¹ argued that:

Consideration could also be given for companies to explain in the remuneration report in a simple and concise manner how awards granted in previous years are tracking against targets previously disclosed (in terms of number (rather than

²⁶⁹ Ernst & Young.

²⁷⁰ ASA.

²⁷¹ CSA.

value) of shares/other securities that would vest if the award was tested at the end of the financial year in question as if it was the real date of testing of the award) or if they have vested or forfeited in the financial year in question.

That respondent noted however that:

this is not a simple task and has the risk of overly complicating the remuneration report. CSA would not be in favour of attempting to forecast the likely prospects of vesting of particular awards in the remuneration report or attempting to attach a value to such forecasts. CSA notes that it should be made clear to readers of the remuneration report that in relation to awards that have not yet vested, the maximum number of securities that can vest is not necessarily what the executive will receive.

One view expressed at the Roundtable was that any mandatory system for tracking previously granted but still unvested remuneration would require a company to report on remuneration that reflects a decision taken by a remuneration committee at some prior period (which could be a number of years for longer-term incentive arrangements). Rather, the remuneration report should focus on the decisions that directors are making on remuneration for the current financial year and the links to performance hurdles. An unintended consequence of a mandatory tracking system may be that, to avoid ongoing disclosure, companies will shorten the period of vesting of long-term incentives, which may be a perverse outcome for shareholders.

3.17.3 Advisory Committee position

Companies may choose in their remuneration reports to keep shareholders informed about remuneration arrangements previously entered into, but not yet vested.

A legislative obligation to provide this information in the remuneration report is not warranted. The primary focus of that report should be on decisions that directors made on remuneration arrangements in the current financial year. The imposition of a tracking obligation may detract from this focus and would have the potential to confuse the presentation of the remuneration report.

3.18 Benefits on termination

3.18.1 The issue

Subparagraph 300A(1)(e)(vii) provides that, if a member of the key management personnel is employed by the company under a contract, the remuneration report must disclose the duration of the contract, the periods of notice required to terminate the contract, and the termination payments provided for under the contract.

In addition, Corp Reg 2M.3.03(1) Item 9 requires the disclosure of that person's termination benefits.

Questions arise as to the adequacy of the coverage of these disclosure requirements where that person departs from the company.

A separate matter, not within the CAMAC terms of reference, concerns the range of termination-related payments requiring shareholder approval under Part 2D.2 Div 2.²⁷²

3.18.2 Submissions

One respondent²⁷³ commented that there is often a discrepancy between contractual termination entitlements disclosed under s 300A(1)(e)(vii) and the payments actually received by an executive upon departure from the company:

In recent years we have noted that the payments received by executives on termination often do not reflect the previously disclosed termination payments provided for under the relevant executive's contract.

That respondent considered that greater details of termination benefits actually given should be disclosed, including:

the contractual provisions that gave rise to the relevant termination or retirement payment, at the time the payment is made.

²⁷² Part 2D.2 Div 2 requires shareholder approval for termination entitlements that exceed one year's base salary.

²⁷³ ACSI.

Another respondent²⁷⁴ considered that s 300A(1)(e)(vii):

should also require disclosure of the contractual basis of any termination payments made to departed executives during the reporting year.

Another submission²⁷⁵ was that for a departing executive the remuneration report should disclose:

the company's rationale for the [termination] payment and the proportion of the payment that was pro-rated for time and performance.

There was a view at the Roundtable that bundling together in the remuneration report all components of remuneration that were received by an executive on termination can create confusion and give a false impression about the basis for those payments.

3.18.3 Advisory Committee position

CAMAC considers that the remuneration report should provide adequate disclosure of all the benefits given to any member of the key management personnel on his or her retirement. This would assist shareholders in understanding termination practices and help overcome misconceptions that may arise concerning payments made to departing executives.

The disclosure obligation in s 300A(1)(e)(vii) is too narrow in various respects. It only covers termination payments provided for under a contract of employment, not non-contractual payments on termination. Also, payments disclosed under this provision can be reported as a lump sum, without disclosure of the elements of those payments. Corp Reg 2M.3.03(1) Item 9 requires the disclosure of termination benefits, but lacks the specificity needed to overcome the limitations of s 300A(1)(e)(vii).

Shareholders would be better informed about benefits given on a person's termination if, in addition to termination payments provided under the employment contract, the remuneration report also provided information on any discretionary payments made to

²⁷⁴ ISS.

²⁷⁵ Ernst & Young.

that person in connection with his or her termination. For instance, the board may have exercised a power under a share plan to provide a payment to a departing executive, even though that person had not fulfilled all the preconditions for payment. A board may also have given a departing executive a gratuitous bonus or other benefit, including a payment to forestall or settle a dispute over the circumstances of that person's termination. These may be additional to payments made under the contract of employment and therefore would not come within s 300A(1)(e)(vii).

A board might also enter into an arrangement with a departing executive for that person to provide consultancy or other services to the company in the future. This type of post-termination arrangement could have significant financial consequences for both the company and the former executive.

To ensure adequate disclosure of the different possible types of termination benefits, the legislation should require that the remuneration report separately identify:

- *entitlement payments*: amounts paid on termination that reflect statutory and other accumulated payments (for instance, unused annual and long service leave and superannuation entitlement payouts)
- *severance payments*: amounts paid specifically for termination, such as:
 - payments in settlement of, or in consequence of, a potential or actual dispute over dismissal
 - gratuitous and other discretionary payments
- *post-severance arrangements*.

The legislation should require that the report at least disclose the total benefits under *entitlement payments* and *severance payments*, respectively, with a further breakdown under each component within both categories. A separate summary of any *post-severance arrangements* should also be included.

3.19 Pay parity disclosure

3.19.1 The issue

The US *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* requires relevant companies to disclose:

- the median of the annual total compensation of all employees, other than the CEO
- the annual total compensation of the CEO
- the ratio of the median total annual employee compensation to that of the CEO.²⁷⁶

The question is whether a similar disclosure requirement should be introduced in Australia.

3.19.2 Submissions

One submission²⁷⁷ suggested that s 300A be amended to require this type of disclosure if the widening gap between executives' remuneration and standard employee wages is considered to be a concern.

However, other submissions²⁷⁸ opposed this disclosure. One of those respondents²⁷⁹ argued that:

- the likely unintended consequence of this disclosure would be the outsourcing of work done by lower paid employees to external contractors, either locally or offshore
- there is less need for this disclosure in Australia than in the United States, given that:
 - Australian executives are not paid highly by global standards²⁸⁰

²⁷⁶ s 953.

²⁷⁷ Kym Sheehan.

²⁷⁸ Guerdon Associates, BCA.

²⁷⁹ Guerdon Associates.

- Australia has a relatively high minimum wage
- Australia's low unemployment and skill shortages are likely to continue to underpin employee pay growth in the foreseeable future.

The other submission opposing this disclosure²⁸¹ argued that:

- these types of requirements go beyond simplification of reporting requirements and instead raise issues already considered by the Productivity Commission, such as quantum, salary caps and proportions of average earnings
- reporting of proportions of pay relative to average earnings may be meaningless unless it properly acknowledges the risk-based nature of significant elements of modern incentive pay
- under a properly designed, performance-linked remuneration structure, total pay (base pay and incentive/'at risk' pay) may vary significantly from year to year. These changes would require lengthy explanation if they are to avoid confusion
- proportional reporting may deter performance-based pay and lead to de facto limits on executive remuneration. The Productivity Commission stated that 'prescriptive pay constraints (such as caps) ... would be impractical, weaken the role of boards and have perverse economic consequences'.²⁸²

3.19.3 Advisory Committee position

Requiring this form of pay parity disclosure would add to prescription, without any clear rationale. It is also arbitrary in that any number of comparisons between the remuneration of key management personnel and that of other groups in the company, the industry sector, or society generally could be made.

²⁸⁰ PC report at 80.

²⁸¹ BCA.

²⁸² at 357.

3.20 Remuneration outcomes

3.20.1 The issue

Depending upon the remuneration arrangements agreed between a company and a member of the key management personnel, that person may receive in the current reporting period all or some of the following:

- remuneration that was granted to that person at some previous time (whether conditional or unconditional) and is paid in the current financial year (crystallized past pay)
- remuneration that was granted to that person in the current financial year and is paid in that year (present pay)
- conditional or unconditional remuneration entitlements, payment of which is deferred to some future period (future pay).

The legislative architecture for remuneration reports does not deal specifically with whether each of these categories of pay should be disclosed.

The question is whether a remuneration report should include all or only some of these remuneration outcomes. A particular issue concerns whether crystallized past pay should have to be reported.

3.20.2 Productivity Commission

The Productivity Commission recommended that the remuneration report should include ‘actual levels of remuneration received by the individuals named in the report’.²⁸³

This recommendation was adopted in principle by the Government.²⁸⁴

²⁸³ PC report, rec 8.

²⁸⁴ *Australian Government Response to the Productivity Commission’s Inquiry on Executive Remuneration in Australia* (April 2010), p 6, rec 8.

3.20.3 Submissions

The AICD Position Paper considered that the remuneration report should disclose ‘actual pay’, which ‘should be based on when the remuneration vests’ (when the right an executive has to the remuneration in question crystallizes), and, in addition, ‘current entitlements to future remuneration’:²⁸⁵

A key part of remuneration reporting is not just what key senior personnel have ‘earned’ during the current reporting period, but also what they are entitled to ‘earn’ in future periods.²⁸⁶

The AICD Position Paper considered that the category of entitlements to future remuneration generated in the current reporting period should be clearly distinguished from remuneration outcomes in the current year.²⁸⁷

Another submission²⁸⁸ argued that a remuneration report should provide an outline of remuneration outcomes for each of the key management personnel, set out according to *realisable remuneration* (covering crystallized past pay and present pay) and *remuneration grants received* (covering present pay and future pay):

Realisable remuneration would cover remuneration paid to the person in the current financial year, whether generated in the current financial year or at any time in the past. This category is designed to reflect remuneration received by key management personnel ‘in the hand’ in the current financial year.

As some of this remuneration might be realised in the financial year but relate to remuneration granted in previous years, the company would have to provide an explanation of which amounts relate to remuneration granted and realisable during the financial year and which amounts were granted in previous years but became realisable in the financial year.

Remuneration grants received would cover all remuneration generated by the individual in the current financial year, whether paid immediately to that person or deferred to some

²⁸⁵ AICD Position Paper at Sections 2.6 and 2.7.

²⁸⁶ id at Section 2.7.

²⁸⁷ ibid.

²⁸⁸ Guerdon Associates and Allens Arthur Robinson.

future period, and whether guaranteed or ‘at risk’. This category is designed to reflect remuneration that the company has committed itself in the current financial year to pay key management personnel, now or in the future (subject to performance or other conditions).²⁸⁹

These grants would not include crystallized or realised pay received in the current financial year that is the result of remuneration policy adopted by the company in earlier fiscal periods. That remuneration would be included under *realisable remuneration*, in recognition that many stakeholders are interested in what remuneration has crystallized and been paid.

A contrary view was that remuneration to be reported should be confined to present pay and future pay (equivalent to *remuneration grants received*), excluding crystallized past pay:

Macquarie’s view is that the actual pay *awarded* in the current year should be included in the Remuneration Report. This will enable shareholders to see how the remuneration awarded is aligned with the current year’s performance. Actual pay awarded would include any remuneration approved by the Board for an individual’s performance in a given year. This would show fixed remuneration, variable/and or performance based remuneration, equity awards and any other incentives granted in the year.

Macquarie does not consider that it is appropriate to mandate that actual pay *received* in the current year should be included in the Remuneration Report. The actual pay *received*, being broadly cash received and awards vested in the current year (in relation to remuneration awarded in prior years), is not the main focus of Board decision making regarding remuneration. For deferred remuneration, a number of factors may change during the vesting period, for example the economic climate, market conditions and the composition of the Board. The actual pay *received* approach

²⁸⁹ According to that submission:

Remuneration grants received would comprise:

- *fixed remuneration* (including cash, fringe benefits and superannuation), contingent on service;
- *incentives* (including *short-term incentives*, *long-term incentives* and any other types of incentives), contingent on performance (with disclosure of the contingencies on which it is being paid); and
- *other benefits*, being remuneration which is not contingent on service or performance (for instance, termination or sign-on pay).

will include deferred awards when they vest. Therefore, there is no alignment between current year company performance and remuneration.²⁹⁰

3.20.4 Advisory Committee position

It is a matter for each company to settle the remuneration mix with each of its key management personnel, including to what extent these remuneration arrangements include performance-related or other future pay, entitlement to which will crystallize in some future reporting period.

To ensure that shareholders are given full information on remuneration outcomes, the report should include, for each of the key management personnel, actual pay received by that person, being present pay and any crystallized past pay, and, in addition, any remuneration entitlements granted in the current reporting period, but deferred as future pay.

Companies would continue to have adequate opportunity to make clear to shareholders in the remuneration report those components of pay outcomes that reflect remuneration arrangements from previous financial years.

²⁹⁰ Macquarie Group Limited.

Appendix 1 Terms of reference



The Hon Chris Bowen MP
Minister for Human Services
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 would 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.

2

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 Suggestions for content of the remuneration report

This appendix sets out suggestions from Ernst & Young and Macquarie Group Limited on the structuring of a remuneration report.

Ernst & Young

Suggested 'ideal' remuneration report

Structure and overview of content

A key differentiator that can make a remuneration report comprehensible to shareholders is a clear and logical structure that makes use of headings, tables and diagrams where relevant. Such a structure must be complemented by clearly marked disclosures which provide meaningful information to shareholders on the company's remuneration approach and why this approach is appropriate, given the company's context and business strategy.

The following suggested remuneration report template and content overview is intended to meet these needs:

Topic	Contents
Part A: Executives	
1. Overview/ summary	Description of the company's executive remuneration framework in terms of fixed remuneration and incentives, noting any key changes to the framework in the current year. Key details of current year approach: incentive payments (and vesting) and rationale, termination payments and rationale, and any one-off payments. Details of any expected reviews of, or changes to, remuneration structures in the coming year.
2. Remuneration strategy	Remuneration objectives, approach to quantum, approach to remuneration mix, key objectives of each remuneration element (e.g., fixed remuneration, incentives, retention payments) and details of any significant changes.

Topic	Contents
3. Incentive plans	<p>Detailed plan descriptions, including overview of the performance measures in the plan, rationale for their selection, their weightings, targets and vesting schedules. An exception should be provided for targets that are commercially sensitive, which will typically apply only to plans with short-term performance targets, but may apply to other incentive plans that use company-specific commercially sensitive targets.</p> <p>Details of any outstanding equity grants (i.e., name of plan, grant date, award vehicle, number of instruments and vesting dates, but not the accounting value of the awards).</p>
4. Remuneration opportunity and contracts	<p>Summary of each executive's remuneration opportunity for the year:</p> <p>Fixed remuneration (as at the start of the year and any amendments made during the year).</p> <p>Cash incentive opportunities (target and maximum, to the extent the company has specified opportunities).</p> <p>Equity incentive opportunities (expressed as a dollar value or a percentage of fixed remuneration with an explanation regarding how this is converted into a number of shares/rights/options).</p> <p>Contractual information:</p> <p>Length of contract, notice periods, sign-on arrangements, termination entitlements and details of any guaranteed payments.</p>
5. Performance and reward link (including remuneration outcomes)	<p>Table presenting current year and prior year individual remuneration data using 'actual' values [see section 1.2.2 of the Ernst & Young submission for a discussion regarding the presentation of 'actuals').</p> <p>Summary of cash-based incentives paid in the year to each executive. This should include the amount of cash paid in relation to service over the year (i.e., excluding any deferral) and the cash value of any longer-term incentives or retention payments that were paid during the year.</p> <p>For the payments that relate to the current year performance, disclosure should include a high-level summary of the company and executives' performance against targets, the total payment earned (dollar value and as a percentage of maximum), and the split between immediate cash payment and deferral.</p> <p>For payments that relate to multi-years, disclosure should provide a summary of the incentives that was paid during the year, including an explanation of what period the amount relates to and how the value has changed over the period.</p> <p>Summary of current year share-based payment vesting by executive, including performance against the relevant hurdles, the number of awards that vested and the value of the vested awards at the date of vesting.</p> <p>Summary of the changes in each executive's company shareholdings (number of shares held) and dollar value over the year (split to show both (a) wholly owned shares, vested but restricted shares and vested but unexercised options; and (b) unvested equity awards). Value of equity to be based on</p>

Topic	Contents
	share price at year-end less any exercise price (if applicable). Details of termination payments made in the current year, including a breakdown of the components of the payment and the rationale for the payment (with reference to contractual entitlements). See Appendix B of the Ernst & Young submission for an example of how a company may present the information described above.
Part B: Non-executive directors ('NED')	
6. NED policy and outcomes	Description of the company's NED remuneration framework: fee pool, policy base fees, committee fees, benefits and participation in equity plans, noting any key changes to the framework in the current year Current year and prior year individual remuneration data using 'actual' values

The above remuneration report would be supplemented by the Notes to the Annual Financial Report, which would include details of the aggregate accounting value of KMP remuneration outcomes (by remuneration element) and a description of the fair valuation methodology used for share-based payments.

Macquarie Group Limited

General principle: shareholders should be provided with sufficient information in the Remuneration Report to be able to evaluate a company's remuneration policy and remuneration outcomes in light of the company's performance.

Summary of suggested items for inclusion in the Remuneration Report

Executive summary

Remuneration Framework/Policy

Description of the remuneration framework, including the key elements, the underlying principles and evolution over time.

Remuneration Governance

Description of governance framework managing and monitoring executive remuneration, description the Board oversight process, the function and responsibilities of the Board Remuneration Committee, and details of the remuneration approval framework.

Remuneration strategy

Description of the goals of the remuneration policy and the remuneration arrangements implemented to achieve them.

Performance and pay link

Description of how performance goals and remuneration strategy are aligned, description of alignment to shareholder goals and discussion of remuneration components and tools used to achieve this. Explanation of how remuneration arrangements are delivering performance outcomes including relevant benchmarking against peers

Incentives

Discussion of remuneration incentives, structures including

- fixed remuneration,
- variable performance based remuneration,
- delivery and retention of performance based remuneration
- investment of retained amounts
- vesting schedules
- performance hurdles
- minimum shareholding requirements and
- significant contractual termination arrangements.

Remuneration outcomes

Remuneration table for KMPs outlining remuneration awarded, including fixed salary, total performance based incentives split by category, for the current and previous year.

Non-executive director policy and outcomes

Description of the non-executive remuneration policy, details of current and previous year fees and shareholding requirements.