Submission on Exposure Draft Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 and supporting Explanatory Memorandum dated 20 December 2010 ('the Bill')

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20 January 2011

Executive Summary

CRA Plan Managers Pty Limited (CRA) is a specialist remuneration advisory and employee share scheme advisory practice, based in Sydney. CRA made a submission to the Productivity Commission Inquiry into Executive Remuneration in Australia, a summary of which appears in **Appendix A.**

Most of the legislative responses to the Productivity Inquiry were anticipated. Where the proposed legislative response exceeds the scope of the PC's recommendation we recommend that no such change be adopted without further detailed inquiry and consultation with all affected parties.

A summary of our specific comments and recommendations in relation to the Bill are as follows:

- **Strengthening the non-binding vote – the 'two-strikes' test.** The legislative response contained in the Bill reflects the Productivity Commission's **recommendation 15** and was anticipated. Potential for unforseen outcomes and current market practice make changes unwarranted.

- **Improving accountability on the use of remuneration consultants.** The legislative response proposed is draconian and far exceeds the scope of the Productivity Commission's **recommendation 10** and should not be introduced. The definition of Remuneration Consultant is too broad and unworkable. The context of remuneration consulting services is ill defined and unworkable.

- **Prohibiting KMP from voting on remuneration matters.** The legislative response reflects the Productivity Commission's **recommendation 4** and was anticipated.

- **Prohibiting hedging of incentive remuneration.** The legislative response reflects the Productivity Commission's **recommendation 5,** so far as it relates to unvested equity or vested equity subject to holding locks, and was anticipated. The proposed legislative changes, however, extends well beyond the scope of the recommendations, creates uncertainty and should be significantly redrafted.

- **No vacancy rule.** The legislative response reflects the Productivity Commission's **recommendation 1** and was anticipated.

- **Cherry Picking.** The legislative response reflects the Productivity Commission's **recommendation 7**, but extends beyond the Productivity Commission recommendations to include member voting generally which was not anticipated.

- **Persons required to be named in the remuneration report.** The legislative response reflects the Productivity Commission's **recommendation 9** and was anticipated.

- **Regulation impact statement**. Generally the consultation references used to support deviation from the PC's recommendations are insubstantial at best, and do not provide adequate consideration of the potential impact of the changes and therefore should not be considered.

<u>The timing of the issue of the Exposure Draft (20 December 2010) and the timeline to make submissions (by January 2011) will result in totally inadequate exposure and consideration in respect of issues that will extremely broad impact on Australian listed Corporations. Significantly longer and broader 'exposure' is recommended to avoid unforeseen and adverse consequences.</u>

1. Introduction

CRA Plan Managers Pty Limited (CRA) made a written submission to the Productivity Commission (PC) Inquiry into Executive Remuneration Australia. A summary of our comments and recommendations made to the Productivity Commission are set out in **Appendix A** of this submission for your reference.

CRA is an independent company principally involved in advising listed and unlisted companies in all aspects of contemporary remuneration design and incentive strategies for their executives and employees. The majority of CRAs clients are public companies in the mid-cap range and larger unlisted companies, although CRA has also provided advice, from time to time, to a number of top 100 companies. CRAs principal consultant, Mr Ian Crichton, has worked in the remuneration advisory industry for more than 15 years. He is the author of the Top 500 Report analysing senior executive and director remuneration in Australia's largest 500 companies by market capitalisation, since 1995.

Our submission contained in this brief paper is in response to the Exposure Draft in respect of ***Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*** and the supplementary Explanatory Memorandum. Our responses are set out in the order of the Chapters in the Explanatory Memorandum.

The responses are brief because of the unreasonable time constraints imposed. The Exposure Draft was released on 20 December 2010. A copy of the Exposure Draft was not provided to us despite the fact we had made a detailed submission to the Productivity Commission. We became aware of the Exposure Draft when our office reopened after the Christmas break on 10 January 2011. Given the complexity of the issues and the potential impact of them we do not believe 30 days over a Christmas period is a reasonable timeframe to allow for complete and reasoned responses from affected parties. We have canvassed all of our major clients this week and none of them were aware of the Exposure Draft or the timeline for responses.

In our view the timing of the release of the Exposure Draft and the timeline for responses is most unreasonable and is contemptuous of Australian listed companies, their Board's and their advisors and should be extended to ensure adequate and complete exposure is provided to all affected parties. Without further exposure and consultation it is our view that incoherent and inappropriate laws with all manner of unforeseen consequences will result. Look no further than the legislative process undertaken in the ESS legislation changes over the course of 2009 as a warning of uninformed and ill considered change.

2. Strengthening the non-binding vote – the 'two-strikes' test

The legislative response contained in the Bill reflects the Productivity Commission's **recommendation 15** and was anticipated.

The incidence of a greater than 25% 'no vote' in Australia's public companies over the most recent reporting season is negligible. Prescriptive legislation to 'fix' a problem that does not exist seems moot.

Because it is moot, the change will have negligible impact on most companies, if any.

Our specific comments including concerns with the changes proposed are summarised as follows:

1. The opportunity for cynical use of the test to cause a spill;
2. If faced with a 'second strike' possibility and therefore a spill some shareholders may vote in favour of a Remuneration Report they do not agree with in order to avoid the spill, resulting in a quite contradictory outcome to the intended purpose of the Bill;
3. A 'no vote' on a Remuneration Report does not mean a company has inappropriate remuneration practices. It could simply mean that institutional shareholders have exercised a 'donkey' vote following proxy advisor or other shareholder advocacy group recommendations that were inadequately or inappropriately researched;
4. A 'no vote' can arise, particularly with retail investors, because the complexity of disclosure of many company Remuneration Reports, makes them unintelligible to other than the most sophisticated users. If you don't understand something then voting 'no' or abstaining is a likely result.

Our detailed analysis of the recent June 2010 reporting season indicates that the 'no vote' on remuneration reports are having an effect on Board behaviours and practices. It is our opinion that there is no need, therefore, for a prescriptive response which will carry uncertain and unforseen outcomes.

3. Improving accountability on the use of remuneration consultants

The legislative response proposed is draconian and far exceeds the scope of the Productivity Commission's **recommendation 10,** which states "*Companies to disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company. ('If not, why not')*". The extent of the changes proposed goes much further than was anticipated and will create a myriad of unforeseen consequences if adopted in its current form.

The proposed legislation implies the relationship between companies and their remuneration advisers and the nature of their work is 'fairly standard' and easily regulated by enforcing prescriptive lines of appointment and reporting. Regrettably, business strategies and the executive remuneration strategies that support them is anything but standard, nor are the interrelationships between management, Boards and their advisers standardised.

CRA supports the intent of **recommendation 10** made by the Productivity Commission but opposes the scope of changes proposed in the Exposure Draft.

Our specific comments include:

1. **Definition of '*remuneration consultant*' *(Schedule 1, Item 5, subsection 206K(2))***

   In our view, the definition contained in the Exposure Draft is completely inadequate and will lead to uncertainty and/or inconsistency of application. For example, are the following services and the people that provide them "remuneration consultants"? If not, why not?

   - A lawyer who assists a company with the drafting of an Employment Agreement, including the components of remuneration, in connection with the appointment and/or promotion of an executive?

   - An 'executive search' consultant who interacts and negotiates on behalf of a company and/or an executive in determining the terms of an appointment?

   - A performance management consultant who assists a company develop a strategic performance incentive scheme, to determine amongst other things the key performance criteria to adopt in an employee incentive program, which may require

extensive analysis and consultation with business unit heads, finance and the Chief Executive Officer, to be effective?

- A consultant charged with the task of undertaking a 'job evaluation' assessment for all positions and grade levels within a company. Again, to fulfil their obligations this consulting process will require extensive interaction with many levels within an organisation, including the CEO?

- An employee share scheme (ESS) advisor assisting a company understand and deal with a complex set of design issues, including accounting issues, legal issues, taxation issues, HR issues, performance, service and other vesting issues and other related complexities?

There is an endless list of examples we could pose where the work entailed by a consultant may impact on executive remuneration, but where the work is incidental to and not fundamental to the Board's requirement to have senior executive remuneration tested and reported on by an independent remuneration consultant.

2. **Engaging remuneration consultants**

The Bill, as proposed, requires that only Non-executive Directors can execute a contract to engage a remuneration consultant.

In the 'real' world, the engagement of a remuneration consultant is often to serve different purposes. It is not only to serve as an independent assessment of senior executive remuneration for the benefit of Non-executive Directors.

Services provided by remuneration consultants, all of which may constitute remuneration advice in relation the CEO and Key Management Personnel (KMP) and therefore be covered by the Bill, may include, but is not limited to the following:

- Job sizing and evaluation consulting;
- Executive recruitment;
- Remuneration benchmark assessment and evaluation across all employee groups;

- Salary packaging advice;
- Employee engagement surveys and motivational analysis;
- Strategic performance review and analysis;
- Employee share scheme consulting and advice;
- Remuneration strategy review and advice;
- Remuneration report preparation advice;
- General Meeting Notice preparation and advice;
- Investor sentiment survey and advice;
- Non-executive Director fee benchmark survey, analysis and advice;
- CEO remuneration benchmark survey, analysis and advice; and
- Senior executive (KMP and others) remuneration benchmark survey, analysis and advice.

To undertake the above referenced work remotely and in isolation, through engagement by a part-time intermediary (i.e. a Non-executive Director) will impose completely unrealistic, bureaucratic and dysfunctional engagement processes.

The 'one size fits all' coverage of the Bill exposes a lack of appreciation by the legislators of the scope and complexity of the remuneration and human resources consulting experience in contemporary competitive companies.

The impact of the Bill will be most deeply felt by smaller companies, where, by their nature, advisors often provide multiple services to a company to be cost effective, whereas larger companies often may engage separate specialist service providers for each service, because of their more complex requirements and financial capacity to pay.

3. **Advice from remuneration consultants**

The Bill, as drafted, proposes making 'remuneration consultants' guilty of a criminal offence if they provide advice (remuneration) to a prohibited person. This is absurd. This will effectively mean a 'remuneration consultant' would be reluctant to engage in any interaction with a prohibited person for fear of unwittingly providing advice and thereby committing a criminal offence.

How can a remuneration consultant begin to do their job (See 2. above for an example of the scope of works covered) without an in depth understanding of the nuances of each business, its strategies, culture and even the mindset of the people (prohibited persons) that the remuneration strategy will attempt to motivate, retain and incentivise.

By its nature, remuneration advice often requires a close interaction with the executives most affected by the advice. To undertake this work remotely and in isolation, through a part-time intermediary will result in a blancmange of inappropriate, plain vanilla, standardised solutions unsuited to the dynamics of a contemporary business.

4. Impact of the proposed changes, may include:
   - The proposed changes increase the costs of doing business for all remuneration consultants, which will lead to higher company costs;
   - The proposed changes will lead to a much higher work load, particularly for the Chairman of the Remuneration Committee, which will most likely lead to both higher Board fees and a reduction in the number of qualified Board members willing to accept the burden of the responsibilities imposed leading generally to poorer practices;
   - The proposed changes will create a bureaucratic overload of compliance focussed work completely unrelated to improving remuneration practices and therefore be counter productive; and
   - The proposed changes will lead to a more superficial consulting engagements resulting in standardised rather than user focussed outcomes.

5. What the proposed changes **will not** impact on, include

Automatic Rotation

One of the supposed reasons for introducing the changes is because it is felt that a remuneration consultant may be compromised by providing advice that is unfavourable to the CEO or the KMP because of the impact of obtaining future work.

Irrespective of the proposed dysfunctional engagement processes a remuneration advisor who is concerned about future work will be compromised.

One way to fix this is to make certain remuneration advisory functions compulsorily rotational. That is, for example, no remuneration consultant, or firm, is able to provide certain clearly defined remuneration consulting functions for more than 2 years in any 5 year cycle, or similar.

Quality of the Advice

The proposed changes do not address the quality of the remuneration advice, merely its supposed independence.

By imposing overbearing bureaucratic compliance processes it will lead to standard advice of a generally poorer quality.

Licensing, training and professional development

The proposed legislation imposes the potential for criminal liability arising on 'remuneration consultants' without the industry being regulated in any way. Until we know what a 'remuneration consultant' is. Who is qualified to be one? What standards of education, training and professional development they must meet the legislation is 'putting the cart before the horse'. All this will do is lead to material uncertainty and probably significant unintended non-compliance.

4. Prohibiting KMP from voting on remuneration matters

The legislative response reflects the Productivity Commission's **recommendation 4** and was anticipated.

If the current law does not prevent this obvious 'conflict of interest', then any changes to do so are supported by CRA.

5. Prohibiting hedging of incentive remuneration

The legislative response reflects the Productivity Commission's **recommendation 5,** so far as it relates to unvested equity or vested equity subject to holding locks, and was anticipated.

The proposed legislative changes, however, are not so clear cut. The proposed legislation makes no reference to equity or unvested equity, but refers to prohibiting the exposure to '*limiting an element of remuneration that depends on the satisfaction of a performance condition'.* This is not what the Productivity Commission intended and therefore the proposed Bill extends beyond the scope of the Productivity Commissions recommendations and is opposed by CRA.

Some of the uncertainty that arises in our mind based on the drafting of the proposed Bill, includes:

1. Are only performance conditions covered by the Bill? What about service conditions and other vesting restrictions? Is this intended?
2. Is Income Protection Insurance limiting an executive's exposure to risk? If so, this was not intended by the PC recommendation.
3. Is Life Insurance limiting an executive's exposure to risk? If so, this was not intended by the PC recommendation.
4. Is 'salary packaging' limiting an executive's exposure to risk? If so, this was not intended by the PC recommendations.
5. Is holding an employee share scheme (ESS) interest in the name of an Associate, as is permitted under the taxation laws limiting an executive's exposure to risk? If so, this was not intended by the PC recommendations.

It is our opinion, the proposed Bill is poorly drafted, extends beyond the intended scope of recommendations made by the PC and should be extensively amended, if not completely rewritten.

6. No vacancy rule

The legislative response reflects the Productivity Commission's **recommendation 1** and was anticipated.

We support any legislation that increases shareholder's input on Board size and composition and have no specific comments on the legislation proposed because it is outside our area of specialist expertise.

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7. Cherry Picking

The legislative response reflects the Productivity Commission's **recommendation 7**, but extends beyond the Productivity Commission recommendations to include member voting generally which was not anticipated.

We do not support legislative change based on a whim rather than thorough and broad consultation for fear of creating unforseen consequences. Having said that, we have no specific comments on the legislation proposed, because it is outside our area of specialist expertise.

8. Persons required to be named in the remuneration report

The legislative response reflects the Productivity Commission's **recommendation 9** and was anticipated.

We support any legislation that simplifies the disclosure requirements in the remuneration report.

Our specific comments however include:

1. The technical and regulatory detail required to be disclosed in the Remuneration Report makes the information unintelligible to other than the most informed readers and leads to gross misstatement of executive rewards by unscrupulous commentators and therefore has done little to improve the community or stakeholders understanding of the remuneration paid to executives. We would urge legislators to implement the PC **recommendation 8**, as a priority;
2. For consistency and to give appropriate balance in the debate of 'fair and reasonable' remuneration the value of remuneration entitlements of all senior Government employees (including accrued future benefits annualised) should be made subject to the same rigorous standards of accounting and disclosure that applies to listed Corporations. There is currently a material distortion between reporting for public companies and public owned enterprises (including Government) which unfairly focuses undue attention on the productive areas of commerce only. This in our view is a very unhealthy trend.

9. Regulation impact statement

The Regulation impact statement included in the Explanatory Memorandum is lengthy. We limit our comments to two key areas only, as follows:

1. The consultation process used to support the proposed changes makes no reference to the consultation group or the Productivity Commission extending the legislation change in respect of Hedging Equity Incentive to include other than unvested equity or equity subject to a Holding Lock.

2. The decision to extend the legislative change beyond the scope of Productivity Commission in respect of the process of engaging remuneration consultants by the Board only seems to rely solely on the recommendation by KPMG, Fidelity International and Oppeus. That is, the legislators have relied on recommendations from an accounting firm, an insurance company and an executive search firm to argue for change. This is at best extremely limited support from organisations whose principal areas of expertise lies somewhere other than remuneration.

Appendix A

Summary of recommendations to the Terms of Reference (TOR) of the Productivity Inquiry into Executive Remuneration

TOR 1: Trends in remuneration

Table 4 - Trends in CEO and Chairman remuneration relative to other growth indicators

Director and relativity	1999 ($'000)	2008 ($'000)	Value Increase ($'000)	% Increase	Compound Annual Growth Rate %
CEO TFR Median	409	523	114	28%	**2.77%**
CEO TFR 75th percentile	624	902	278	45%	**4.18%**
CEO TFR + STI Median	465	686	221	48%	**4.42%**
CEO TFR + STI 75th percentile	792	1,370	578	73%	**6.28%**
Chairman Median	89	151	62	70%	**6.05%**
Chairman 75th percentile	152	300	148	97%	**7.85%**

Measure	1999	2008	Total Increase	% Increase	Compound Annual Growth Rate %
AWE (*)	610	891	281	46%	**4.30%**
AFL Players AAGE (*)	117	214	97	83%	**6.94%**
CPI (*)	101	136	35	35%	**3.36%**
ASX/S&P 300 (*)	13,138	33,860	20,722	158%	**11.09%**

Public Servant	1999	2008	Total Increase	% Increase	Compound Annual Growth Rate %
Chief of the Defence Force	305	429	124	41%	**3.86%**
Auditor-General for Australia	285	401	116	41%	**3.87%**

(*) 1 July 1998 to 1 July 2008

Prima facie, analysis of the CEO or Chairman's remuneration data over the period (with LTI excluded) would not support the premise that remuneration paid to CEO's or Chairman of Australian public companies is excessive.

TOR 2: Effectiveness of regulatory arrangements

In our opinion, heavy handed and prescriptive regulation, particularly in a subject that is so fluid and requiring 'real time' judgement, may create distortions, lead to unforeseen outcomes, often resulting in practices that are less effective than the system it replaced, or at the extreme lead to intentional avoidance.

The four (4) most recent influential 'regulatory' changes that have, in our opinion, had the most profound impact on senior executive remuneration are:

1. Remuneration disclosures in respect of directors and key management personnel (KMP).
2. The non-binding vote by shareholders on Remuneration Reports
3. The introduction of AASB – 2 (Accounting for Share based payments).
4. Changes to taxation rules affecting ESS announced by the Treasurer – 12 May 2009, and subsequent refinements

TOR 3: The role of institutional and retail shareholders

The proxy advisers generally adopt a 'standards based' or 'checklist based' analysis in formulating their recommendations.

A review of the standards commonly applied (sourced mainly from CGI Glass Lewis's "Green' Paper) may highlight for the Committee some of the anomalies or inconsistencies that can result from a formula based approach. See **Appendix J**.

TOR 4: Aligning interests

In our opinion, most of the answers to this complex issue lies in significantly improved research, regular checks and balances by a truly independent third party and vastly improved communication, not based on legal and accounting requirements, but that discloses 'real' benefits received and that are comparable across all companies.

TOR 5: International developments

The very establishment of the Commission is probably a reaction to the 'excessive' remuneration debate internationally that some contend helped cause the recent Global Financial Crisis (GFC). Hopefully, the Commission's conclusions will show that Australia's remuneration practices, generally have been somewhat more sober than our international counterparts.

Several key aspects of senior executive remuneration that have evolved overseas and where Australia is poorly equipped with its current taxation regime to match world's 'best practice', include:

1. Deferred bonuses paid in employer company shares;
2. Long term shareholding, post vesting; and
3. Taxing point for options.

TOR 6: Liaising with the Tax System Review and APRA

Co-ordination between the various regulatory authorities would be ideal, however, somehow in Australia we have evolved a system where our adopted Accounting Standards determine that share based payments represent an expense to the business even where the equity benefit never vests, yet our taxation system does not recognise it as an expense. Conversely, our taxation system proposes to tax a benefit that is only notional and may never be received, which is unrecognised as a benefit by our Accounting Standards.

This emphasises the need for education and communication to ensure Government, regulators, investors and Boards understand the differences and the impact on financial statements.

TOR 7: Recommendations on improving remuneration practices

In no particular order the following recommendations, if adopted, in our opinion, would improve remuneration practices or at least improve the understanding of the practices adopted:

1. Introduction of a supplementary statement for remuneration disclosures which is completely standardised and contains all the key remuneration information in easy to understand and readable format;
2. Significantly greater quantitative analysis in assessing all 'at risk' remuneration, including 'risk' analysis;
3. Rotation of Board appointed remuneration advisors on a regular basis. No more than three years;
4. Mandatory and appropriate qualifications for all Remuneration Committee participants;
5. Mandatory requirement that all remuneration instructions and advice is strictly between the Board and the remuneration advisor, without intervention or direction from the CEO or other executives;
6. Ensuring that remuneration advisors are not conflicted. That is, it would be inappropriate for a remuneration advisor or their firm, for example, to provide legal, taxation or audit services to a company;
7. Alignment between taxation and accounting expense for all equity incentives;
8. Significant standardisation and simplification of the method of valuing equity incentives to allow for better understanding and comparison between companies for all financial statement users;
9. Mandatory reporting of all company provided equity incentive benefits realised by senior executives;
10. Establishment of a public company 'Remuneration Review Tribunal' to review and report on public company remuneration practices;
11. Funded research to guide remuneration practices in Australia relative to local and overseas 'best practice' standards; and
12. Appropriate accreditation of all Board remuneration advisors.